United Nations E/1999/15

Economic and Social Council

Distr.: General
19 April 1999

Original: English

Substantive session of 1999
Geneva, 5–30 July 1999
Item 10 of the provisional agenda
Regional cooperation

Summary of the economic survey of Europe, 1998

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Overview of recent economic developments and selected policy issues in the Economic Commission for Europe region[1]

A. Current economic situation in the region

1. Introduction

1. The crisis that hit the world economy in 1997 with the devaluation of the Thai baht persisted through 1998, with powerful boosts from the Russian devaluation and debt moratorium in August 1998 and the Brazilian crisis in the second half of 1998. Although the particular circumstances of each incident are different, they have been linked by financial contagion and its subsequent effects on real activity and international trade. In early 1999, the crisis is by no means over: despite a large emergency support package from the International Monetary Fund (IMF), Brazil was forced to let its currency float, and by the end of February, it had depreciated by about 40 per cent against the dollar, which in turn is likely to have ripple effects on other countries in the region. The collapse in commodity prices, especially of crude oil, is creating serious stability problems for oil producers, not least in the Middle East, and there is still much uncertainty over the economic outlook in China and the possible implications this might have for policy in that country, especially with regard to the exchange rate.

2. Although its weight in the world economy is relatively small, the Russian currency and debt crisis in August 1998 had a much greater destabilizing effect on the international financial markets than the Asian crisis of 1997, and its repercussions for other countries in the Economic Commission for Europe (ECE) region, especially the transition economies, were generally more serious. Some of the financial effects — such as the drop in stock market prices, including in some of the central European economies — were due to portfolio adjustments as investors liquidated positions in healthier markets to offset their losses in the Russian Federation. But the key element was a fundamental reassessment by investors of the risks and attractiveness of investing in emerging market economies. Much of the foreign investment in the Russian Federation had entered when an IMF-supported programme was being followed, and no doubt investors assumed that if anything went wrong any losses would be avoided with the help of a bail-out organized by IMF, as was the case in South-East Asia. That assumption was proved false in the Russian case, and consequently there were considerable fears in September–October of a global recession being triggered by the falls in stock prices and the threat of a "credit crunch" as credit conditions were tightened significantly, not only for borrowers in emerging markets but also in developed market economies, such as the United States, where the spreads over United States Treasury Bills for corporate borrowing rose significantly. There were also large fluctuations in the value of the dollar against the European currencies, especially when there were exaggerated fears for a short while for the stability of the German banking sector because of its exposure to Russian borrowers. These tensions were eased by the series of cuts in United States interest rates between the end of September and mid-November, and by the coordinated cut in interest rates in early December by the 11 future members of the European Monetary Union (EMU). Stock prices have recovered from their levels of autumn 1997, especially in the United States, and a measure of calm has returned to the financial markets. But this may well be deceptive. The financial turbulence of the last 18 months or so has plunged large areas of the developing world into recession, and the deflationary consequences for trade in goods and services and investment income has led to a steady lowering of growth forecasts for 1999 both in Western Europe, where the steady deterioration in net export growth has not been offset by stronger domestic demand, and in many of the transition economies, where the slowdown in the growth of import demand in Western Europe, together with the increased costs of international borrowing (for those who still have access to it), imply a tighter balance of payments constraint on their growth rates in 1999.

2. Western market economies

3. Throughout 1998, the adjustments to the crisis continued to be supported by strong growth in the United States, where GDP grew by just under 4 per cent for the second year running. This was underpinned by the continued willingness of United States consumers to spend virtually all their disposable income and by the buoyancy of business investment, especially in information technology. But it is becoming increasingly uncertain how long this benign process can continue. Although inflation has not picked up, one consequence of the consumer boom is a record trade deficit, which is increasing rapidly and depends on the willingness of foreign investors to continue financing it. In the short run, this may not be a problem since the increased aversion to risk means that for investors there are few other safe havens capable of providing liquid assets on a large enough scale, but this cannot last indefinitely if the deficit continues to widen. Similarly, private expenditure has been supported by the fall in oil prices, equivalent to a large tax cut[2] which is unlikely to be repeated in 1999, and by very

high levels of borrowing against stock market gains. The growth in the latter cannot continue indefinitely, and when the correction eventually comes there is likely to be a swift return to positive savings rates. The question is not whether this will occur but when and whether the adjustment will be mild or impose a sharp shock on the economy. In fact, the projected further widening of the United States current account deficit to quite a high level in 1999 requires, in principle, a change in domestic policies to bring about an increase in net exports. This will have to rely on both a reduction in domestic absorption and a depreciation of the dollar. Given the tight labour market, a weakening of the dollar alone would lead to mounting inflationary pressures. The ensuing tightening of monetary policy would then risk pushing the economy into recession (the "hard landing" scenario). The extent of domestic policy and exchange rate changes, however, will depend on the strength of domestic demand in Asia and Western Europe. Given the well-known problems in Japan and the Asian emerging economies, this explains why the United States authorities are keen to see a faster rate of growth in Western Europe.

4. Like the United States, Western Europe initially benefited from the hardship suffered by the rest of the world: the large fall in the prices of commodities and to a lesser extent of a range of Asian manufactured goods led to a substantial improvement in their terms of trade, which in turn kept down the already small rates of increase in consumer prices and boosted real disposable income. In addition, the "flight to quality" in the financial markets made it easier to reduce interest rates in a number of countries. However, in sharp contrast to the United States, growth in Western Europe was well under 3 per cent in 1998 (see table 1) and was slowing down throughout the year, particularly in the third and fourth quarters. The failure of domestic demand to offset the weakening of net exports largely reflects the tighter stance of macroeconomic policies over the last few years. Fiscal policy was for the most part broadly neutral in 1998, but this follows two years of severe fiscal retrenchment in the run-up to the introduction of the euro, and the present stance of policy makes no allowance for the weakening cyclical position in the region. Moreover, the rules of the Stability and Growth Pact for EMU members leave virtually no room for fiscal manoeuvre should the cyclical slowdown become more severe. In order to prepare for a fiscal response to a future downturn in the next millennium, the authorities appear to be prepared to tighten fiscal policy to reduce structural budget deficits during a possible slowdown now. Monetary policy also appears to be too tight in the euro area: although nominal interest rates are at historically low levels, real rates are still relatively high. A cut in interest rates and a postponement of the target dates for reducing structural budget deficits would improve the prospects for economic growth in Western Europe. If this is achieved, progress in reducing the budget deficits would be greatly eased, as the United States experience has shown, and it would also strengthen investment and lower unemployment. The unemployment rate averaged 10.9 per cent in the euro area in 1998, and was starting to rise again towards the end of the year. The situation is especially worrying in Germany, where economic growth slowed sharply in the second half of 1998 and where the unemployment rate was 9.1 per cent in January 1999. Given the importance of the German economy both for Western Europe as a whole and many central European economies, the concerns of the German authorities about the current stance of economic policies should be seen as a European not simply a national issue. Expectations for growth in Western Europe in 1999 were still being lowered in the closing months of 1998, and the average forecast has now slipped below 2 per cent. On past experience, this implies no further reductions in unemployment and in all likelihood it will start to rise again.

3. Transition economies

5. The global economic crisis and the associated financial instability have begun to have a severe impact on the transition economies. At first, the principal direct effect of the Asian crisis was on the primary commodity producers of the Commonwealth of Independent States (CIS), notably the Russian Federation, where falling oil prices have had a significant impact on export earnings and contributed to the crisis in August 1998. For most of Eastern Europe, the direct impact was small because its predominant trade links are with Western Europe. But the subsequent collapse of Russian imports was nevertheless significant for a number of East European exporters in 1998, especially the Baltic States, which still have relatively large trade shares with the Russian Federation. With the weakening of West European import demand in the course of the year, there has been a rapid deterioration in the economic performance of the transition economies since the Russian crisis of summer 1998, a process which appears to have accelerated in the closing months of 1998 and in early 1999. The financial contagion from the Asian and Russian crises was relatively limited, even for the few countries which are relatively more integrated with the international financial markets, but the real threat, as was pointed out in the 1998 *Survey*, lay in the real economy and the possibility of a sharper than expected slowdown in Western Europe. Unfortunately, this is what has occurred, and the highly export-dependent economies

of central and eastern Europe are being subject to a severe external demand shock.

6. The slowdown in economic growth in 1998 occurred in virtually all the East European and Baltic economies, and was generally more severe than was expected earlier in the year. (Hungary is the principal exception, so far, to the general recessionary trend.) Instead of improving on the relatively weak performance in 1997, gross domestic product (GDP) in Eastern Europe rose on average by just 2 per cent, less than half the rate implied by the official forecasts and nearly a percentage point lower than in 1997 (see table 2). The Baltic economies did rather better for the year as a whole (just over 4 per cent), but the deceleration from the 1997 rate was considerable.

7. For the leading reform economies and the Baltic States, the relatively strong growth of the last few years was broken in mid-1998, largely by the deterioration in external conditions, but weak domestic factors also played a role, especially in South-East Europe. Some slowdown had been expected in some of the faster growing countries because of measures taken to check a too rapid growth of consumer spending and rising current account deficits, but the deceleration was much more than anticipated. The full extent of the slowdown is still not fully reflected in the statistics, partly because many of the data are not yet available and partly because of lags, for example, between the inflow of export orders and actual deliveries. But the industrial production figures point to a rapid deceleration through the year, from a year-on-year average growth in Eastern Europe of just over 6 per cent in the first quarter to 1.4 per cent for the year as a whole. These aggregate figures conceal a wide variation in national economic performance, but broadly speaking, in most of the faster-reforming and faster-growing economies of Central Europe and the Baltic States, the growth rates of industrial production have fallen considerably, while in South-eastern Europe the recession in industry worsened in the second half of the year.

8. The deterioration in economic performance is also reflected in the labour markets, where the modest improvements in the levels of employment slowed down or were reversed in most of the transition economies during 1998 and unemployment rates rose sharply from mid-year. In December 1998, the unemployment rate averaged 12.6 per cent in Eastern Europe, up from 11.6 per cent in June; in the Baltic States it ended the year at 7.3 per cent, a full percentage point higher than 12 months earlier. Unemployment has also continued to rise sharply in January and February 1999, although this partly reflects the seasonal effects of a hard winter. In the CIS, the picture is also one of sharply deteriorating economic performance. Particularly hard hit by both the Asian and Russian crises, output has fallen (or at best growth has been severely weakened) and the slender gains of 1997 have been more than offset.

9. One of the crucial elements in the situation now facing the transition economies is the deterioration in their current accounts, all of which are in deficit (see table 3). These deficits averaged about 4.5 per cent of GDP in Eastern Europe in 1998, but the range was considerable, from 1.5 per cent in the Czech Republic, which is now in a deepening recession, to some 7 per cent in Croatia and Romania and about 11 per cent in Slovakia; in the Baltic States, the proportions range from nearly 10 to 13 per cent. The majority of these deficits were deteriorating throughout the year, and towards the end of 1998 most of them were much larger than even the more pessimistic forecasts made at the start of the year. For most of the East European and Baltic economies, imports were still rising faster than exports in 1998, and given the deterioration in their export prospects the question arises as to how long the present deficits can be sustained. The more rapidly growing economies of the last few years — Croatia, Hungary, Poland and Slovakia, for example — have all had large increases in their current account deficits, underlining the dependence of the transformation process on imports and foreign borrowing. But this import-dependent growth could be increasingly constrained in 1999 by at least three factors: the risk of a tightening of policy in some of the transition economies, shortfalls in capital inflows and the increased cost of foreign borrowing, and the slowdown in West European growth. The official forecasts for the transition economies (see table 2) still point to an average rate of growth of just under 3 per cent in Eastern Europe in 1999 and some 4.5 per cent in the Baltic States. But these are now looking very optimistic and it is increasingly likely that the actual outcomes will be much lower.[3] In the CIS countries, a fall in the average level of output appears unavoidable, but how large it will be is greatly dependent on what happens in the Russian Federation. Given the sharp slowdown that now appears to be under way, this is not the moment to tighten fiscal policy in the transition economies, although the discussions in some of them suggest that this may be the intention. Such action, combined with an external demand shock, would intensify the downturn and ultimately be self-defeating by creating larger rather than smaller budget deficits. If anything, there is room for a loosening of monetary policy since in a number of countries real interest rates rose sharply in 1998 and were one of the domestic factors that contributed to the slowdown.

10. A faster rate of growth (and of import demand) in Western Europe is highly desirable as the best way of supporting growth in the transition economies and also

heading off the increasing pressures for protection from Eastern imports, pressures which have already led to anti-dumping actions being started for a number of products. Western Europe is running a large current account surplus not only with the world but also with the transition economies. In the first nine months of 1998, the European Union (EU) alone had a trade surplus of about $16.5 billion in its trade with Eastern Europe and the Baltic States. If a faster growth rate in the EU cannot be achieved, ways should be found of recycling part of the EU current account surplus to the transition economies, especially to those which face increasing difficulties in raising funds on the international capital markets. This could involve official transfers or loans, but however it is implemented, the key point is to recognize that the West European current account surplus is having a deflationary impact on the countries of Eastern Europe and the Baltic States. If the EU, as the major economic power in the region, acts with a broader sense of responsibility towards all the countries in the area, such measures would not only help to sustain growth and structural change in the transition economies but would also provide positive feedback to the EU itself: in 1998 Eastern Europe and the Baltic States imported about $100 billion worth of goods from the EU — that would seem to be large enough to be worth preserving and expanding.

B. Strong policies and weak foundations

11. Apart from their deleterious effects on the world's economies, the Asian and Russian crises have led to increased questioning of the economic policies which have been pursued for the last two decades or so, principally under the aegis of the Group of Seven leading market economies and the Bretton Woods institutions. What became known as the "Washington consensus" was a set of policies that were developed in response to the inflation crises in the developed market economies in the 1970s and 1980s and to the Latin American debt crisis in the 1980s. The consensus comprised two major elements, one concentrating on macroeconomic stability and the other on so-called supply-side reforms which would underpin both macro-stability and create the basis for spontaneous and sustained economic growth. Macroeconomic stability, reflecting the experience noted above, focused essentially on lower inflation and then pre-empting any further outbreak with strict and attentive monetary policies. At the same time, not only were general government budget deficits to be lowered in order to support the objectives of monetary policy but the level of government spending was also to be reduced as much as possible, the assumption being that the smaller the role of the State, whether in the actual production of goods and services or in its attempts to intervene in the workings of the economy, the better would be the economic performance of the private sector and of the economy as a whole. The programme of supply-side policies followed from the latter point: product and factor markets should be deregulated as far as possible, State-owned assets and supply of services should be privatized and international trade and capital markets liberalized. More recently, a proposal to change the IMF articles of agreement to include capital account convertibility as an ultimate objective for all members was made by the Fund's Interim Committee in September 1997 — this would enable the Fund to insist on a country liberalizing its capital account as one of the conditions for receiving IMF assistance.

12. This "mainstream" policy framework was firmly in place when the communist regimes of Eastern Europe and the former USSR collapsed between 1989 and 1991. Confronted with economies dominated by State-owned enterprises and widespread government intervention and characterized by high levels of economic inefficiency and extensive restrictions on private initiative, the advice from most Western Governments and the international financial institutions was derived directly from the Washington consensus: the transition to a market economy could best be made by liberalizing and privatizing the economy as quickly as possible, while macroeconomic policy should establish and maintain low rates of inflation and balance in the general government and current accounts. Previous issues of the *Survey*[4] judged that this approach greatly underestimated the task of creating a market economy: it focused on too narrow a set of exclusively economic variables and ignored the risk that liberalization without the appropriate institutional infrastructure was unlikely to establish a functioning and "efficient" market economy. Macroeconomic stabilization was unlikely to lead to sustainable development unless accompanied by a carefully sequenced programme of structural reforms. Moreover, in many transition economies, and the Russian Federation was a prominent but not unique example, it was difficult to see how the standard macroeconomic policy package could easily be applied when the banking and financial sector was so underdeveloped that the links between the real and financial sectors of the economy were too weak to support the use of traditional monetary instruments, or when Governments were unable to control their expenditure and revenue because there was no functioning fiscal system.

13. In several respects, many of the policies recommended by the mainstream consensus have come dangerously close to being dogmas based on oversimplified models and

incomplete evidence. The certainty with which they are proposed and pursued is not reflected in the available empirical evidence. This tendency to simplification is not confined to the policy recommendations for transition and developing economies.

1. Unemployment

14. Unemployment in the European Union is by all accounts its major political and social problem and its major economic failure. The standard analysis from most of the international economic institutions and from Western Europe's central banks is that the problem is essentially structural and must be tackled by measures to make labour markets more flexible rather than by policies to boost demand and output. However, comparisons with the United States, the usual exemplar in matters of labour market flexibility and lowering unemployment, do not suggest an unequivocal difference between Europe and America. Real wages in Europe appear to have been flexible in the 1980s and do not appear to have been more rigid than in the United States;[5] and, more recently, one leading labour economist has concluded that the assertion that European unemployment is high because European labour markets are "rigid" is too vague and probably misleading. Many labour market institutions that conventionally come under the heading of rigidities have no observable impact on employment.[6] There is little evidence that reducing employment protection is a solution to high unemployment, although active labour market policies may help people to find work. Virtually every fall in unemployment in Western Europe in the last two decades or so has been accompanied by an easing of macroeconomic policy (either fiscal expansion, or lower interest rates or devaluation etc.). Thus, without demand increased flexibility can have no effect. Restrictive macroeconomic policies over a long period,[7] linked more recently to the objectives of the Maastricht Treaty, have kept growth well below the 3 per cent annual average forecast when the Single Market was completed, and in turn have led to an adjustment in productive capacities consistent with a lower expected rate of growth and an unemployment rate of about 10 per cent.[8] Lowering unemployment will therefore need stronger demand, but to be sustained there will also need to be more investment. Profit shares are now higher than they were in the 1970s and the 1980s, but real long-term interest rates, which were very high for a long time, have fallen only slightly below those in the United States (which is at a very different stage in the cycle) and need to fall further if investment is to rise and capacities to expand sufficiently to absorb the unemployed. In sum, a significant cut in unemployment in the EMU area requires a period of above-average rates of investment and of output growth.[9] This goes against the grain of the ruling policy prescription, but as one leading macroeconomist has observed, it is necessary to underline that the international policy makers' "story" about the rise in unemployment and way to cure it might be badly flawed. The confidence with which the prescription is administered does not yet correspond to a convincing mass of evidence.[10]

2. Inflation

15. The reduction and control of inflation occupies a prominent position in the Washington consensus, and has clearly been given high priority in Western Europe and the transition economies. This was a reaction to a general acceleration of wage pressures in Europe in the late 1960s and the cost-push effects of the two major oil shocks of the 1970s. The key argument for focusing on inflation as a principal objective of macroeconomic policy is that it distorts the information content of the price mechanism, and by disrupting the basic coordination system of the market economy reduces the propensity to invest and hence economic growth. Also, high rates of inflation are often accompanied by high rates in its variability and this also has a negative effect on expectations. The justification for continuing to give priority to inflation control, even when it has virtually disappeared in Western Europe, is that without an attentive monetary policy it can quickly accelerate and veer out of control again. But both the costs of inflation and the dangers of acceleration once any slippage is allowed may be exaggerated. The evidence suggests that inflation is costly in terms of lost output only when annual rates exceed 40 per cent — then there is a danger that high inflation will lead to low growth rates.[11] Below this rate, growth and investment can recover even though inflation is still in double digits: the important element is that there are expectations that it will remain on a downward trend. In most of the transition economies, annual inflation rates are now below 20 per cent, with many in single digits, but paradoxically there appears to be a positive relationship between output growth and the average inflation rate between 1993 and 1998.[12] However, this reflects differences not so much in the rate of inflation but in its rate of deceleration over the period: where a more gradual approach has been adopted, conspicuously among the leading reformers, output growth has been rapid and investment encouraged. In contrast, the excessive emphasis on rapid price stabilization in the Russian Federation, for example, involving increasingly tight monetary policy, has had highly negative effects on the real economy and has contributed to the growth of payments arrears and other

perverse outcomes.[13] Moreover, the persistence of moderate rates of inflation in much of Central Europe reflects a continuing adjustment of relative prices as administrative controls are gradually lifted, adjustments which actually represent improvements in the market system. It would not be sensible to react to such price increases with tighter monetary policy. Nor is it necessarily desirable to accelerate the process of freeing controlled prices (it is well known and accepted that public and semi-public housing rents are heavily subsidized in the transition economies and that a move to more economic levels is necessary for an improvement in the housing stock, but this cannot be done abruptly as the subsidies are an important part of the social safety net in these countries).

16. In Western Europe, inflation rates are practically zero at the present time, yet policy is still deeply concerned that small monthly increases could set off another inflationary surge. But the evidence suggests this concern is misplaced: there appears to be no grounds for believing that inflation is related to previous rates of increase[14] and therefore little risk of an acceleration getting out of control. Moreover, this pre-emptive stance of monetary policy, at insignificant rates of inflation, appears to make no acknowledgement of the fact that inflationary expectations have changed significantly since the 1970s and 1980s, and that the structural and technical changes that have occurred in the developed economies since then have reduced the likelihood of present wage and price setting behaviour being quickly reversed. However, the belief that monetary policy will be tightened in response to minor upward deviations from set targets has a depressing effect on expectations of output growth and the propensity to invest. The view that close-to-zero inflation is a necessary and even a sufficient condition for strong, sustained growth and falling unemployment is not based on historical evidence. But continuing to focus on such an objective is likely to have deleterious effects on the prospects for reducing the currently high rates of unemployment in Western Europe.

3. Trade liberalization

17. The weak links between strong policy recommendations and the supporting empirical analysis are not confined to the labour market and domestic prices. The transition economies were advised in 1989 that price and trade liberalization could not be introduced gradually despite the experience of Western Europe, which phased out its wartime price controls in line with supply-side improvements to avoid boosting inflation, and which together with North America started to liberalize its foreign trade gradually over a long period starting in the 1940s, a process that is still not complete.[15] The recommendation for rapid trade liberalization was supported by an influential World Bank study of 17 countries, which concluded that a bold liberalization tends to be more sustainable than one which is staged. But in a careful review of this seven-volume study, it was pointed out that the great diversity of experience of the individual countries did not support the extravagant claims made for the generality of the study's conclusions.[16] A similar degree of uncertainty surrounds the relationship between trade liberalization and faster economic growth, a crucial issue since liberalization is essentially an instrumental policy, not an end in itself. Some economists[17] find a close and positive relationship, emphasizing the benefits of removing the static and dynamic costs of import substitution; others[18] contend that the presumed relationship depends on the validity of specific microeconomic assumptions, which rarely appear in reality, and that once increasing returns to scale and productivity-boosting investment are brought into the picture, the standard case for liberalizing trade to boost growth breaks down and a plausible case for interventionist policies can be made. Again, a careful review of the empirical evidence underlines its inconclusiveness — it is possible that trade liberalization may in fact favour output growth but not in a straightforward manner, and that in the short run the adjustment costs may predominate over the benefits.[19]

18. The argument for trade liberalization is that exposure to increased competition will force domestic enterprises to be more efficient, and the more quickly this is achieved the better. However, there are two points to emphasize here. First, the scale of the adjustment shock of liberalizing trade will depend on how far the domestic output, employment and relative price structures have to change in response to the new competitive pressures. For many transition economies, the scale of restructuring required by the shift from central planning to competitive markets is so large that the domestic economic, political and social institutions, which are also in a state of transition, are unable to cope with the adjustment costs, which in turn may generate large-scale resistance to reform (the study of Romania in the current *Survey* provides a telling example of this).

19. Second, economic growth and development is a highly complex process, the causes of which are still poorly understood; but economic historians, and economists outside the neoclassical persuasion have always emphasized the crucial role of institutions in stimulating and facilitating the process of change and of mobilizing and expanding the resources available for development. In the presence of a heavily distorted output structure, weak corporate governance and the absence of appropriate institutions —

the situation in many transition economies — rapid trade liberalization may be more likely to lead to unemployment and stagnation rather than economic growth and positive structural adjustment. But generalizations are difficult. Poland, Hungary and to a lesser extent the Czech Republic appear to have gained from opening their economies to international trade, but there is little sign of similar responses in Romania or the Russian Federation or many of the other countries that are lagging behind in the process of reform. It is sometimes argued that the transition economies where GDP growth has been most rapid are those where liberalized trade and current accounts emerged quickly, where structural reform was rapid and where inflation was falling, so that the countries that are succeeding the best are the countries that followed the IMF policy closest, and the countries that are lagging behind — Romania is an example — are the countries that were least able to stick to the strategy.[20] But such cross-country comparisons do little to establish the direction of causation. An alternative view is that the most successful reformers appear to be those where the initial conditions — in terms of both the required scale of restructuring and the institutional capacity to handle it — were more favourable to a faster rate of transition. In other words, Governments were able to implement — and their electorates were willing to tolerate — a faster rate of change than in other transition economies. But this means that the pace of reform is largely determined by the historical legacy and not only by the choice or the political will of Governments.

4. Liberalization of international capital flows

20. The liberalization of the international capital markets is perhaps one of the most controversial elements in the ruling orthodoxy, especially since the Asian crisis broke in August 1997. The official case for free capital movements is that it is merely an extension of the argument for free trade in goods — countries with insufficient domestic savings to finance their own investment can draw on the surplus savings of others,[21] and by searching out the most profitable projects foreign capital will lead to a more optimal allocation of world resources and a convergence of per capita incomes. However, although the estimated benefits from free trade may also be controversial, there is no doubt that serious efforts have been made to quantify them, and there is a body of evidence which points to significant gains even if these range considerably in size. In the case of capital account convertibility, attempts to quantify the benefits, as Professor Bhagwati has pointed out,[22] are virtually non-existent and are more a matter of repeated assertion than careful analysis. In fact, the available evidence casts doubt on many of the presumed major benefits of free capital movements. Contrary to expectation, domestic investment and domestic savings rates tend to be closely correlated across countries: different rates of return on capital persist and are not equalized by foreign capital flows.[23] This is not so surprising if it is recalled that different rates of return will affect the flows of foreign capital, other things being equal. But "other things" are not equal in most of the transition and developing countries: legal and institutional structures are often inadequate to attract foreign investment, while economies of scale and conglomeration in the highly integrated economies of Western Europe and North America still provide the major attraction for investors. Some 80 per cent of the Organisation for Economic Cooperation and Development foreign direct investment still flows to other OECD countries,[24] and despite the large absolute flows to the rest of the world in the 1990s, most portfolio investment in the United States and Western Europe still goes into United States and West European shares, respectively. Despite popular claims to the contrary, both capital flows and international trade are still more regionally concentrated than truly global.[25] This helps to explain — but only helps since there are many complex factors involved — why there is little evidence in favour of income convergence in the world economy.[26]

21. Nor do the great benefits claimed for free international capital markets appear to be reflected in better economic performance, irrespective of its distribution. Growth rates of GDP in the last two decades have generally been much lower than in the 1960s, in both the developed and developing countries, and investment ratios (to GDP) have generally fallen. Although there are many factors involved in this deterioration and it should not be denied that some countries have benefited from increased liberalization, the proponents of unfettered international capital movements cannot claim that they have been generally associated with higher growth rates, more efficient resource allocation or a more equitable distribution of incomes per head.

22. What is clear, however, is that the liberation of international capital flows, particularly by the developed market economies, has been accompanied in the 1980s and 1990s by a considerable increase in financial market volatility — interest rates, exchange rates and capital flows themselves all exhibit very much larger fluctuations than in the 1960s and early 1970s. Sudden inflows and equally sudden outflows of foreign capital create considerable difficulties for the management of domestic monetary policy;[27] the resulting uncertainty and higher risks implied by financial volatility lead to caution on the part of Governments (which tend to set interest rates higher than

they might otherwise have been) and of private business (faced with increased costs of capital and increased uncertainty over future demand). The net result is a tendency for growth rates to fall below what is feasible,[28] a particularly serious consequence for the transition economies intent on closing the considerable income gap between themselves and the members of the EU.

23. The other aspect of financial volatility is its propensity for contagion, the tendency for a financial crisis in one country or region to spread to others largely irrespective of the state of the economic fundamentals in the latter. Contrary to the textbook model of large numbers of investors making careful independent judgements as to profitable opportunities, the capital markets are subject to bouts of "herd behaviour" — that is, investors follow one another without forming their own judgements or expectations about individual economies. Contagion is reinforced by the adjustment of portfolios whereby losses or margin calls in one market are balanced by the liquidation of assets in other markets which may very well show no weakness at all in the real economy — indeed, in this context, the stronger and more liquid markets may be the more vulnerable. Herd behaviour turns into a classical financial panic when foreign investors rush for the exit when their expectations change, for whatever reason. This can trigger a run on the currency, a collapse in the domestic bond market and a liquidity squeeze on the domestic banks, as happened in Asia in 1997 and the Russian Federation last summer. Although the origins of the crisis may be due to faults in the domestic economy where it began — clearly the case in the Russian Federation[29] — the panic tends to amplify the crisis beyond anything that might be justified by the original causes.

24. In the immediate aftermath of the Asian crisis, there was a tendency to put the blame for it not on the instability of the capital markets but on the countries themselves — internal weaknesses, such as weak regulatory frameworks, poor systems of corporate governance, a general lack of transparency in the financial and banking sectors, "crony" capitalism and so on. The question is not whether such deficiencies exist but whether they played a significant role in causing and propagating the crisis. The argument that lack of transparency etc. somehow deceived foreign investors into placing their funds in these countries is difficult to accept since these weaknesses have long been known to be part and parcel of the definition of economies as "developing" or "in transition". Weak financial and banking sectors may make the crisis worse, but capital flow reversals appear to be the main culprit in amplifying the initial crisis and transmitting it to other countries.[30] What countries are affected and how badly will depend on the extent of their integration into the international trade and financial structures. On the whole, the transition economies of Central and Eastern Europe were less severely hit by financial contagion from the Asian and Russian crises than by the increased cost of borrowing on the international markets and the subsequent real economy effects on their exports, as reflection of the fact that their integration in world trade has proceeded much further than in the financial markets.[31]

25. The policy question that arises from the above is whether it is possible to reduce the instability of the international capital markets, and if not whether countries can protect themselves against surges in capital inflows and their sudden reversal. Proposals to improve regulatory systems, improve transparency and generally improve the flow of accurate information in — and between — national economies are desirable in themselves as means to more effective market systems, but as suggested already, it is unlikely that deficiencies in these areas in the transition and developing countries played a major role of causing the crisis. The more serious weaknesses of governance and regulation would instead appear to be located in the developed market economies of North America and Western Europe. The collapse of the Long Term Capital Management (LTCM) hedge fund in September 1998, for example, focused attention on the excessive leverage available to such funds under the available regulations and the fact that at the same time such funds were able to escape from all regulation by the United States Federal Reserve. Also, there appear to have been "cosy" relationships between hedge funds, on the one hand, and the investment and commercial banks on the other. This is another area where there have been frequent and justified calls for more effective monitoring and regulation by central banks; and questions have been raised about Western banks' credit evaluation procedures, which allow excessively large exposures to hedge funds and other institutions to develop without proper monitoring. Swift action to repair some of these deficiencies in the developed market economies could make an important contribution to reducing instability; not only are these the principal sources of international capital flows but they are also the countries where both the urgency and the capacity for reform are greatest. There does not seem to be any reason why such reforms should have to wait for the more comprehensive proposals for reforming the international financial system.[32]

26. Another reaction to the consequences of the Asian crisis has been for greater stress to be placed on the need for a more gradual approach to the liberalization of capital accounts and for effective financial institutions to be in place before capital account convertibility is introduced. Since the Russian crisis, the impression is often given that this has

always been the approach, but in his resignation letter in mid-1998 the Chairman of the Interim Committee of the IMF Board of Governors felt it necessary to warn that it was important to proceed cautiously and with good advice. No country should be forced to liberalize immediately or to remove controls when they are justified by legitimate reasons.[33] There is also increased acceptance of direct capital controls of the type applied by Chile, for example, but only as a temporary and emergency measure.[34]

27. In most of the reactions to the Asian crisis and the proposals for reform, only some of which were mentioned above, the underlying assumption is that capital market instability can be tamed by better institutional frameworks, better supervision, greater transparency, and a more careful preparation of transition and developing economies before they enter the liberalized international environment. Although all these steps may help, a more fundamental question is whether instability is inherent to the international capital markets or whether it arises from inappropriate institutions and unwarranted interference in the market mechanism. This is in fact a variation on one of the basic issues over which economists have divided for most of this century — the origins of uncertainty and the source of dislocation in the system of market coordination. One view, exemplified by von Hayek, is that uncertainty is created by the distortion or suppression of information by interfering Governments and central banks; left alone, individuals will show a natural tendency to coordinate their various plans in an orderly and predictable manner. The other view, exemplified by Keynes, located uncertainty and coordination failures not in exogenous sources but in the system itself. Contrary to Hayek, Keynes thought government could play a role in reducing uncertainty and raising expectations. The influence of these two very different points of view about how a market economy works has dominated the post-war period in roughly equal halves, the Keynesian for some 28 years from 1945 and the Hayekian from roughly 1973.

28. The Keynesian view of the inherent instability of capital markets was reflected in the original design of IMF and the post-war international monetary system. Both Keynes and White[35] saw the new institution's primary function as promoting growth via an open international trading system and the preservation of financial stability. International capital flows, which of course were considerably smaller than now, had to be subject to controls because otherwise it was feared that they would develop an independent existence of their own and disrupt rather than support international trade. From the perspective of 1999, when international monetary transactions massively exceed the value of international trade, those fears seem exceptionally prescient.[36]

29. If the view that instability or volatility is inherent in international capital markets is accepted, although it may be reduced by better regulation etc., it may be desirable to accept capital controls as a permanent instrument in the national policy toolkit and to abandon attempts to include capital account convertibility as an ultimate objective for all IMF members. Under present arrangements, legitimate attempts to control foreign capital flows are in fact made by changing interest rates, but these are clumsy tools for this purpose as they may conflict sharply with other national objectives, such as growth or macroeconomic stability. More direct controls, such as those employed in Chile, would help to contain the disruptive effects of surges in short-term capital flows on economic growth, which if successful would actually make the environment more attractive for longer-term direct investment.[37] It should also be stressed that most transition economies possess extremely small financial sectors in relation to global capital flows, most of which come from the more advanced market economies. A minor portfolio adjustment for a large hedge fund, such as LTCM, could deliver a major shock to such an economy. If import surcharges and import disruption clauses can be provided for under World Trade Organization (WTO) rules for merchandise trade, it is difficult to see why similar provisions cannot be allowed in the case of foreign capital flows, especially when the strongest supporters of capital liberalization claim that the arguments for liberalizing trade and capital are equivalent.

30. One of the standard objections to such controls is that it is too late to "turn the clock back", that the process of capital liberalization is unstoppable. This is often little more than self-interested determinism by market operators, and there seems to be no reason why Chilean-type controls could not be adopted by a country if it so chooses,[38] although it is probably advisable to introduce them during a period of relative calm in the financial markets rather than as an emergency measure during a crisis. More to the point, however, is that the majority of central European transition economies still retain a wide array of capital controls;[39] for the most part, inward direct investment is generally free but controls remain on many portfolio flows. These have helped to insulate these economies from the worst effects of financial contagion by the crisis in emerging markets elsewhere, and it would appear to be unwise to abandon them hastily if at all.

31. Another objection to direct controls is to argue that if countries dislike the results of foreign capital inflows they should simply let the exchange rate rise. But this is not very

helpful — how far it would have to rise is uncertain and may increase rather than ease the country's problems. In fact if direct controls are ruled out of court, countries will inevitably seek alternative ways to protect themselves from instability in the international capital markets, which may be more damaging to the market economy system. In the absence of alternatives, the need for such protection will lead to attempts to increase the levels of reserves, which implies aiming for a current account surplus. By definition, not every country can achieve this, but if they all try there will be ever stronger pressure to resort to the traditional range of "beggar my neighbour" policies which will risk undermining the liberal trading system — precisely the consequence that was feared by Keynes and White in the 1940s but ignored by the liberalizers of the 1970s.[40]

5. Conclusions

32. This brief review of a selection of current policy attitudes suggests that they share a number of characteristics. None of them in themselves can be said to be wrong or undesirable, but the confidence with which they are pursued and applied ignores the fact that the empirical support for them is more uncertain and more ambiguous than is usually recognized. In particular, the tendency to downplay or even ignore the differences in institutional structures, which would appear to be a major source of the intercountry variations in their acceptance of and response to market forces,[41] increases the risk of outcomes which are not only less than optimal but actually opposite to those intended. Without the appropriate institutional infrastructures in place, premature liberalization can cause considerable damage to economic social systems and create a severe backlash against programmes for reform and transition to a market economy (there are signs that since the Asian crisis this is increasingly recognized vis-à-vis the financial sector[42] but the lesson applies across the board; failure to deal with monopolistic structures, to create appropriate legal (and enforcement systems), to build patently popular support for the reform programme[43] and so on can all undermine attempts to create a market economy and drive the existing system into stagnation or recession rather than create a new basis for sustained growth. Adapting policies to the particular conditions of individual economies and taking into account a wider range of factors undermines the simplicity of the ruling paradigm, but that may well be a price worth paying if the transition process is ultimately strengthened and opposition to market reforms diminished by more optimistic expectations.

33. The other characteristic that most of these policies share is a tendency towards deflation. This is fairly clear in the case of current policies directed at inflation and unemployment but is less often acknowledged in the case of attempts to implement structural reform at a pace which is too rapid to be supported by a country's institutional framework. When the required adjustment in structure is very large — and for most transition economies the requirements are far from the marginal changes assumed in standard economics textbooks — and the institutional support for transition very weak, rapid liberalization is unlikely to lead to growth. The broader conclusion, however, is that growth and employment have to be restored to a more prominent position among the objectives of policy. The idea that liberalization, structural reform and economic growth can be tackled in a temporal sequence is as mistaken for the transition economies as for the mature Western market economies. Instead, measures directed at supporting growth need to be introduced alongside stabilization and reform programmes in order to establish a mutual support between them.[44]

34. The triumph of capitalism in the second half of the twentieth century was largely based on its ability to regain popular legitimacy via the intervention of government to ensure low levels of unemployment and more acceptable distributional outcomes — capitalism with a "human face". This, essentially, was the "third way" and was derived from a conjunction of the welfare state with Keynesian economic policies (Keynes, it should be remembered, was a liberal who was acutely aware in the 1930s that if ways were not found to make capitalism more socially acceptable then the likely outcome would be a swing to one of the two totalitarian alternatives then on offer). To put it crudely, for any economic system to survive it must deliver the goods and distribute them in a reasonably equitable manner. The former centrally planned economies failed this test and they have been dismantled; but there are many people now living in some of the transition economies who are wondering whether the new market economy, however embryonic, will fail the test as well.

35. Another aspect of late twentieth century capitalism is that it comes in many varieties and is supported by different institutional arrangements. This tolerance of national varieties, however, is increasingly under threat from those who see globalization in normative terms and insist that transition and developing economies should adopt all the values and institutions of the currently dominant market economies. This approach, which is partly reflected in the post-Uruguay agenda of WTO and seeks to harmonize policies and set rules in areas which have traditionally been regarded as matters for national policy and national preferences, carries considerable risks. It represents a radical

change from the original philosophy behind the creation of the Bretton Woods institutions, which was to create an environment of international financial stability that would underpin the development of world trade and allow countries to develop according to their own preferences, subject to their avoiding actions that would "beggar their neighbours". The pursuit of the globalization agenda, however, increasingly appears to deny much room for any national preferences which clash with those of the major market economies.

36. The crucial danger from this is to the market economy system itself, because economic and social preferences are closely entwined in the broader framework of social and political values which underpin a country's institutions including its form of economic organization. This is why in previous issues of this *Survey* there has been repeated stress on the problems of institutional hiatus in transition economies and on the necessity to allow them sufficient time — and to provide them with significant support — to enable the new market institutions to become embedded in the social and political values of the population and to give the institutions time to start working effectively. In a few of the Central European economies, this process is well advanced, but in many others it is not. If the process does not advance, the new market economies will not function properly and will not achieve popular legitimacy. But, equally, if those social and political values — and preferences — are attacked in the name of the new global economy, the chances are that there will be a backlash against that economy rather than a change in values. It is therefore not surprising that an increasing number of distinguished market economists have recently warned of the dangers of pushing the liberalizing agenda too rapidly and too widely.

37. The stability of any socio-political-economic system ultimately rests on three crucial conditions: (a) whether it has **legitimacy**, i.e., whether the rules and procedures according to which authority is conferred and exercised can be justified and can be seen to be rooted in Adam Smith's "moral sentiments of the population"; (b) whether the agreed rules, conventions of behaviour etc. maintain **order** in the system by encouraging acceptable behaviour and penalizing the unacceptable; (c) the **welfare outcome**, which recognizes that popular support for institutions and economic arrangements will not be sustained if the distribution of costs and benefits is considered by too many of the population to be unjust. The instability in the international financial system in the last decade, the aggressive pursuit of an ever-widening liberalization agenda, and the enormously costly turbulence of the last 18 months or so all suggest that the present global system may be moving closer to violating all three conditions.

Notes

[1] This text is a reproduction of ECE, *Economic Survey of Europe, 1999*, chap. I, No. 1. The ECE region consists of all the countries of Europe, the Commonwealth of Independent States, North America and Israel.

[2] One estimate is that the fall in oil prices by over one third between the fourth quarters of 1997 and 1998 added a full percentage point to the increase in consumer spending. See WEFA, *US Financial Markets Outlook*, 11 January 1999.

[3] The possible effects of the armed conflict in Kosovo are, of course, not reflected in this assessment of the outlook in 1999.

[4] For example, ECE, *Economic Survey of Europe in 1989–1990*, chap. 1.

[5] See ECE, "Wage rigidity in western Europe and North America", *Economic Survey of Europe in 1987–1988*.

[6] See S. Nickell, "Unemployment and labour market rigidities: Europe versus North America", *Journal of Economic Perspectives*, vol. 11, No. 3 (Summer 1997).

[7] See G. Worswick, "The scope for macroeconomic policy to alleviate unemployment in Western Europe", in *ECE Discussion Papers*, vol. 2 (1992), No. 3 (United Nations publication, Sales No. GV.E.92-0-27).

[8] See J. Michie, "Unemployment and economic policy", *Development and International Cooperation*, vol. XII, No. 22 (June 1996).

[9] See R. Rowthorn, "Globalization and employment", *Employment Institute Economic Report*, vol. 11, No. 10, January 1998.

[10] See M. Artis, "The unemployment problem", *Oxford Review of Economic Policy*, vol. 14, No. 3 (Autumn 1998).

[11] See M. Bruno and W. Easterly, "Inflation crises and long-run growth", *NBER Working Paper*, No. 5209 (Cambridge, Massachusetts, 1995).

[12] Although it is not suggested that high inflation leads to higher output growth.

[13] See ECE, *Economic Survey of Europe, 1998*, No. 3.

[14] See J. Stiglitz, "Reflections on the natural rate hypothesis", *Journal of Economic Perspectives*, vol. 11, No. 1 (1997); despite popular beliefs to the contrary there was no persistent acceleration in the rate of inflation in the market economies between 1945 and the late 1960s.

[15] Israel also demonstrated in the 1960s that unilateral trade liberalization could be introduced gradually.

[16] See D. Greenaway, "Liberalizing foreign trade through rose tinted glasses", *The Economic Journal*, 103(416), January 1993; and D. Rodrik, "Closing the productivity gap: does

trade liberalization really help?", in G. Helleiner, ed., *Trade Policy, Liberalization and Development* (Oxford, Clarendon Press, 1992).

[17] See A. Krueger, "Why trade liberalization is good for growth", *The Economic Journal*, vol. 108(450) (1998).

[18] See L. Taylor and J. Ocampo, "Trade liberalization in developing economies: modest benefits but problems with productivity growth, macro prices, and income distribution", *The Economic Journal*, vol. 108(450) (1998).

[19] See D. Greenaway, W. Morgan and P. Wright, "Trade reform, adjustment and growth: what does the evidence tell us?", *The Economic Journal*, vol. 108(450), 1998.

[20] See M. Deppler, remarks made at a symposium organized by IMF and the Bundesbank, 2 July 1998, reported in *IMF Survey*, 27 (14), 20 July 1998, pp. 225–226; and P. Desai, *Going Global, Transition from Plan to Market in the World Economy* (Cambridge, Massachusetts MIT Press, 1998).

[21] See S. Anjaria, "The capital truth: what works for commodities should work for cash", *Foreign Affairs*, November/December 1998 (the author is Director of the External Relations Department of IMF).

[22] See J. Bhagwati, "The capital myth", *Foreign Affairs*, May/June 1998.

[23] See M. Feldstein and C. Horioka, "Domestic saving and international investment", *The Economic Journal*, vol. 90(358) (1980).

[24] See OECD, *International Direct Investment Statistics Yearbook* (Paris).

[25] See ECE, "Structural changes in North-South trade, with emphasis on the trade of the ECE region, 1965–1983", *Economic Bulletin for Europe*, vol. 46 (1994), and R. Kozul-Wright and R. Rowthorn, "Spoilt for choice? Multinational corporations and the geography of international production", *Oxford Review of Economic Policy*, vol. 14(2) (Summer 1998).

[26] See UNCTAD, *Trade and Development Report 1997* (United Nations publication, Sales No. E.97.II.D.8) chap. II; R. Kozul-Wright and R. Rowthorn, "Globalization and economic convergence: an assessment", *UNCTAD Discussion Papers*, No. 131 (February 1998).

[27] See ECE, "Surges in capital flows into eastern Europe, 1990–1996", *Economic Bulletin for Europe*, vol. 49 (1997).

[28] ECE, *Economic Survey of Europe, 1998*, No.1.

[29] See UNCTAD-ECE, "The Russian crisis", paper prepared by the secretariats of UNCTAD and ECE for the UNCTAD Trade and Development Board (Geneva), October 1998, available as press release ECE/GEN/98/2 (16 October 1998), and ECE, *Economic Survey of Europe, 1998*, No. 3.

[30] See M. Fratzscher, "Why are currency crises contagious? A comparison of the Latin American crisis of 1994–1995 and the Asian crisis of 1997–1998, *Weltwirtschaftliches Archiv*, vol. 134(4) (1998).

[31] This is not to deny, however, that some transition economies are more integrated than others in the international financial markets (as shown, for example, by the large shares of domestic securities held by foreigners); in these cases, high levels of reserves and high real interest rates helped to reduce the contagion effects.

[32] On the broader agenda for reform, see United Nations, "Toward a new international financial architecture", report of the task force of the Executive Committee on Economic and Social Affairs of the United Nations, New York, January 1999 (known as "the Ocampo Report"); and J. Eatwell and L. Taylor, International Capital Markets and the Future of Economic Policy: A Proposal for the Creation of a World Financial Authority, paper available at www.newschool.edu/cepa.

[33] See resignation letter of Philippe Maystadt addressed to the Managing Director of IMF, *IMF Survey*, 20 July 1998.

[34] The Chilean approach includes sterilized intervention, to avoid excessive appreciation of the exchange rate, supported by restrictions on short-term capital flows as to minimum entry amounts and a one-year delay before they can be repatriated. In addition, there are reserve requirements which differentiate in favour of long-term as against short-term capital inflows. The advantage of these types of control over the much-discussed Tobin tax on foreign exchange transactions is that they can be applied by individual countries whereas the tax requires wholesale international compliance.

[35] Harry Dexter White was chief international economist at the United States Treasury in the early 1940s, and along with Keynes was one of the two principal architects of IMF and the World Bank.

[36] Capital controls came to an end with the collapse of the Bretton Woods system of fixed exchange rates in the early 1970s; that collapse, by transferring the management of foreign exchange risk to the private sector, was a major factor behind the general move to financial deregulation in the 1970s (see Eatwell and Taylor, op. cit.).

[37] The distinction between short- and long-term investment becomes increasingly less significant with full capital account convertibility as access to modern derivatives markets can be used to reduce the differences in liquidity between different assets.

[38] On the effectiveness of capital controls in a number of developing countries and on the dangers of capital account liberalization in a global system that has still to find ways to prevent the international transmission of financial shocks, see UNCTAD, *Trade and Development Report, 1998* (United Nations publication, Sales No. E.98.II.D.6), especially chap. IV.

[39] Slovenia is often singled out as an economy where capital controls have helped to maintain stability in the domestic economy. See H. Davidson, "Slovenia's splendid isolation", *Central European*, November 1998. A useful summary of selected capital controls in 11 transition economies is given in R. Feldman et al., *Impact of EMU on Selected*

Non-European Union Countries, IMF Occasional Paper, No. 174 (Washington, D.C., 1998), table 2.9. According to the IMF index of capital account liberalization (varying from zero to 100, the latter representing maximum liberalization), the least liberalized country was Romania (12.5) and the most was the Czech Republic (73.7). For Hungary it was 59.5 and for Poland 55.3; for all the others it was under 50.

[40] The Secretary-General of UNCTAD recently emphasized the role of financial instability in bringing about the collapse of world trade growth from almost 10 per cent in 1997 to some 3.7 per cent in 1998. R. Ricupero, keynote address to the high-level symposium on trade and development, Geneva, 17 March 1999.

[41] Although some of these institutional arrangements are inimical to market forces and decentralized decision-making, there is no unique set of institutions which describe a market economy. Capitalism comes in a number of institutional variations.

[42] "*Now we know* that the incentive structure — critical for the behaviour of people and firms — is not only indicated by prices. Prices are critical, markets are absolutely essential, but they are not the only things that create the incentive structure of the economy. It's institutions as well", taken from "Institutions matter, says chief economist for Latin America", *World Bank News*, 2 July 1998 (emphasis added).

[43] See ECE, *Economic Survey of Europe in 1992-1993*.

[44] See J. Kornai, "Lasting growth as the top priority: macroeconomic tensions and government economic policy in Hungary", *EBRD Working Paper*, No. 15 (London, December 1994).

Table 1
Real GDP in the developed market economies, 1996–1999
(Percentage change over previous year)

	1996	*1997*	*1998*	*1999[a]*
Western Europe	2.0	2.9	2.7	1.9
Four major countries	1.5	2.3	2.4	1.5
France	1.6	2.3	3.1	2.2
Germany	1.3	2.2	2.8	1.5
Italy	0.9	1.5	1.4	1.8
United Kingdom	2.6	3.5	2.3	0.5
Seventeen smaller countries	3.1	3.9	3.3	2.5
Austria	2.0	2.5	3.3	2.1
Belgium	1.3	3.0	2.8	2.0
Cyprus	2.0	2.5	5.0	4.0
Denmark	3.3	3.1	2.4	1.6
Finland	4.1	5.6	4.9	3.0
Greece	2.4	3.2	3.0	3.2
Iceland	5.5	5.0	5.6	4.3
Ireland	7.4	9.8	8.5	6.3
Israel	4.7	2.7	2.0	1.7
Luxembourg	3.0	4.8	4.7	3.4
Malta	3.8	4.4	7.6	7.5
Netherlands	3.1	3.6	3.7	2.3
Norway	5.5	3.4	2.0	1.0
Portugal	3.2	3.7	3.5	3.0
Spain	2.4	3.5	3.8	3.4
Sweden	1.3	1.8	2.9	2.0
Switzerland	–	1.7	2.1	1.5
Turkey	7.0	7.5	2.4	1.8
North America	3.3	3.9	3.8	3.0
Canada	1.2	3.8	3.0	2.7
United States	3.4	3.9	3.9	3.0
Total	**2.7**	**3.4**	**3.3**	**2.4**
Japan	5.0	1.4	-2.9	-0.5
Total, including Japan	**3.0**	**3.1**	**2.3**	**2.0**
Memorandum items				
European Union	1.8	2.6	2.8	1.9
Euro area	1.6	2.5	2.8	2.1

Source: National statistics and national economic reports.

Note: All aggregates exclude Israel; growth rates of regional aggregates have been calculated as weighted averages of growth rates in individual countries; weights were derived from 1991 GDP data converted from national currency units into dollars using purchasing power parties.

[a] Forecasts.

Table 2
Basic economic indicators for the ECE transition economies, 1996–1999
(Rates of change and shares: percentage)

	GDP (growth rates)					Industrial output (growth rates)			Inflation (percentage change, December–December)			Unemployment rate (end of period, percentage)		
			1998											
	1996	1997	Ex-ante official forecast	Actual outcome	1999 official forecast	1996	1997	1998	1996	1997	1998	1996	1997	1998
Eastern Europe	4.1	2.8	4.3	2	2.9	6.0	5.6	1.4	..	..	..	11.7	11.9	12.6
Albania	9.1	-7.0	10	8*	8	13.6	-5.6	10*	17.4	42.0	7.8	12.3	14.9	17.6
Bosnia and Herzegovina[a]	..	..	..	..	..	87.6	35.7	23.8	3.2	12.2	2.2	..	39*	..
Bulgaria	-10.1	-6.9	3.0	3*	3.7	3.8[b]	-10.2	-9.4	311.1	578.7	0.9	12.5	13.7	12.2
Croatia	6.0	6.5	7.5	3*	1.5-2	3.1	6.8	3.7	3.5	4.0	5.6	15.9	17.6	18.6
Czech Republic	3.9	1.0	1.4-2.6	-2.7	-0.8	2.0	4.5	1.6	8.7	9.9	6.7	3.5	5.2	7.5
Hungary	1.3	4.6	4.0	5	5	3.4	11.1	12.6	20.0	18.4	10.4	10.5	10.4	9.1
Poland	6.0	6.9	5.6-5.8	4.8	4.5	8.3	11.5	4.7	18.7	13.2	8.5	13.2	10.3	10.4
Romania	3.9	-6.9	–	-7.3	-2	6.3	-7.2	-17.0	56.8	151.7	40.7	6.6	8.8	10.3
Slovakia	6.6	6.5	5.0	4.4	3	2.5	1.7	4.6	5.5	6.5	5.5	12.8	12.5	15.6
Slovenia	3.5	4.6	3.5-4	4	4	1.0	1.0	3.7	9.0	8.8	6.6	14.4	14.8	14.6
The former Yugoslav Republic of Macedonia	0.8	1.5	5.0	2.9	6	3.2	1.6	4.5	0.3	4.5	-1.0	39.8	42.5	..
Yugoslavia[c]	5.9	7.4	10.0	2.6	7	7.5	9.5	3.6	59.9	10.3	45.7	26.1	25.6	27.2
Baltic States	4.1	7.6	6.3	4¼	4.5	4.6	9.4	3.6	..	..	..	6.4	6.3	7.4
Estonia	4.0	11.4	5.5-6	4.2	4	2.9	13.4	0.8	15.0	12.3	6.8	5.6	4.6	5.1
Latvia	3.3	6.5	5-6	4*	4	5.5	13.8	2.0	13.2	7.0	2.8	7.2	6.7	9.2
Lithuania	4.7	6.1	7.0	4.5	5	5.0	3.3	7.0	13.1	8.5	2.4	6.2	6.7	6.9
CIS	-3.4	1.1	1.2	-2¾	-1.1	-3.0	2.6	-2.3	..	..	..	6.6	7.6	8.5
Armenia	5.9	3.1	5-6	7.2	4	1.4	0.9	-2.5	5.6	21.8	-1.2	9.7	11.0	8.9
Azerbaijan	1.3	5.8	..	10.0	9	-6.7	0.3	2.2	6.8	0.3	-7.6	1.1	1.3	1.4
Belarus	2.8	11.4	7-8	8.3	4-6	3.5	18.8	11.0	39.1	63.4	181.6	4.0	2.8	2.3
Georgia	11.0	11.3	11-13	2.9	8	6.8	8.2	-2.7	13.6	7.3	11.0	3.2	8.0	4.2
Kazakhstan	0.5	1.7	3.5	-2.5	1.5	0.3	4.0	-2.1	28.6	11.3	1.9	4.1	3.9	3.7
Kyrgyzstan	7.1	9.9	3.6	1.8	2.8	8.8	50.4	4.6	35.0	14.7	18.3	4.5	3.1	3.1
Republic of Moldova[d]	-7.8	1.6	3-3.5	-8.6	-3	-6.5	–	-11.0	15.1	11.1	18.3	1.5	1.7	1.9
Russian Federation	-3.5	0.8	0-0.5	-4.6	-2.5	-4.0	2.0	-5.2	21.8	11.0	84.5	10.0	11.2	12.4
Tajikistan	-16.7	1.7	..	5.3	..	-23.9	-2.0	8.1	40.6	159.9	2.7	2.4	2.8	2.9
Turkmenistan	6.7	-11.4	..	5.0	..	19.7	-32.3	0.2	445.8	21.5	19.8	..	..	..
Ukraine	-10.0	-3.2	0.5	-1.7	-1	-5.1	-0.3	-1.5	39.7	10.1	20.0	1.5	2.8	4.3
Uzbekistan	1.7	5.2	6.0	4.4	4.4	2.6	4.1	5.8	80.0	27.5	..	0.3	0.3	0.4
Total	**-0.4**	**2.0**	**2.6**	**-½**	**0.7**	**0.1**	**3.8**	**-0.9**	**..**	**..**	**..**	**8.1**	**8.8**	**9.6**

	GDP (growth rates)					Industrial output (growth rates)			Inflation (percentage change, December–December)			Unemployment rate (end of period, percentage)		
			1998											
	1996	1997	Ex-ante official forecast	Actual outcome	1999 official forecast	1996	1997	1998	1996	1997	1998	1996	1997	1998
Memorandum items														
CETE-5	5.0	5.5	4.7	3.6	3.6	6.1	9.4	5.0	..	..	..	11.2	9.8	10.2
SETE-7	2.1	-3.1	3.3	-1.9	1.3	5.7	-3.9	-9.2	..	..	..	12.5	14.3	15.4
Former GDR	3.2	1.7	..	2.0	..	3.3	5.8	7.5	..	..	..	17.0	20.8	18.6

Source: National statistics; Commonwealth of Independent States (CIS) Statistical Committee; direct communications from national statistical offices to Economic Commission for Europe (ECE) secretariat (International Monetary Fund and World Bank data for Albania).

Note: Aggregates are ECE secretariat calculations, based on previous period weights at 1992 prices. Output measures are in real terms (constant prices). Forecasts are those of national conjunctural institutes or government forecasts associated with the central budget formulation. Industrial output refers to gross output, not the contribution of industry to GDP. Inflation refers to changes in the consumer price index except for Croatia and the former Yugoslav Republic of Macedonia, for which retail price index is used. Unemployment generally refers to registered unemployment at the end of the period (with the exception of the Russian Federation, where it is the Goskomstat estimate of the International Labour Organization definition, and Estonia, where it refers to job seekers). Aggregates shown are: Eastern Europe (the 12 countries below that line), with sub-aggregates CETE-5 (Central European transition economies: Czech Republic, Hungary, Poland, Slovakia, Slovenia) and SETE-7 (South European transition economies: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, the former Yugoslav Republic of Macedonia, and Yugoslavia); Baltic States (Estonia, Latvia, Lithuania); CIS (12 member countries of the Commonwealth of Independent States); and total transition economies.

Two dots (..) indicate that data are not available; a dash (–) indicates that the amount is nil or negligible; an asterisk (*) after a numeral indicates an ECE secretariat estimate.

[a] Data reported by the Statistical Office of the Federation; these exclude the area of Republika Srpska.

[b] Bulgarian industrial output indices were recently recalculated according to a new methodology and the old series reportedly have been revised back to 1991; industrial output now includes the gross output of all activities of industrial enterprises (and not just the gross output of "pure" industry, as previously published); the figure for industrial output growth in 1996 according to the new methodology (3.8 per cent) differs significantly from the figure for the rate of change of gross industrial output (-9.1 per cent) reported in the national accounts for the same year.

[c] Gross material product instead of GDP.

[d] Excluding Transdniestria.

Table 3
International trade and external balances of the ECE transition economies, 1996–1998
(Rates of change and shares: percentage)

	Merchandise exports in dollars (growth rates)			*Merchandise imports in dollars (growth rates)*			*Trade balances (per cent of GDP)*			*Current account (per cent of GDP)*		
	1996	*1997*	*1998[a]*	*1996*	*1997*	*1998[a]*	*1996*	*1997*	*1998[a]*	*1996*	*1997*	*1998[a]*
Eastern Europe	3.0	5.9	9.8	14.5	6.5	8.6	-9.6	-10.6	-9.5	-3.7	-4.3	-3.7
Albania	5.3	-33.5	..	40.5	-32.1	..	-26.0	-21.1	–	-4.0	-12.0	-0.9
Bosnia and Herzegovina	141.6	87.4	22.2	129.9	29.2	-32.0	-41.3	-43.3	..	..	..	..
Bulgaria	-8.5	0.5	-12.6	-10.0	-3.7	2.2	-1.9	0.3	-4.0	0.2	4.2	-1.0
Croatia	-2.6	-7.6	6.6	3.7	16.9	-2.0	-16.5	-24.5	-18.1	-4.3	-12.1	-5.4
Czech Republic	4.3	2.7	17.0	10.5	-1.3	5.0	-10.2	-9.2	-3.6	-7.6	-6.2	-1.2
Hungary	2.2	21.6	21.3	4.8	17.0	21.3	-5.4	-4.7	-5.7	-3.7	-2.1	-3.7
Poland	6.8	5.4	6.3	27.9	13.9	11.4	-8.9	-11.6	-12.5	-0.9	-3.0	-3.4
Romania	2.2	-4.3	-3.3	11.3	-1.4	7.4	-9.5	-8.2	-8.9	-7.3	-6.7	-6.8
Slovakia	2.8	0.2	8.2	26.6	-8.0	6.5	-12.2	-10.5	-10.2	-11.2	-6.9	-10.1
Slovenia	-0.1	0.8	7.3	-0.7	-0.7	5.5	-5.9	-5.4	-5.0	0.2	0.2	0.4
The former Yugoslav Republic of Macedonia	-4.7	2.8	12.8	-5.4	7.8	9.6	-10.8	-15.5	-14.0	-6.5	-7.4	-6.3
Yugoslavia	20.6	28.7	6.7	54.3	16.7	1.3	-14.2	-13.4	..	..	-7.2	..
Baltic States	17.6	23.0	8.3	26.3	26.7	14.1	-18.6	-22.0	-22.6	-8.2	-9.5	-11.3
Estonia	13.2	40.9	13.0	27.2	37.5	15.0	-26.4	-32.4	-32.7	-9.7	-12.0	-9.7
Latvia	10.7	15.9	12.9	27.6	17.4	22.3	-17.1	-19.0	-20.4	-5.4	-6.2	-9.7
Lithuania	24.0	15.1	2.7	24.9	23.8	9.5	-15.3	-18.6	-19.1	-9.2	-10.2	-13.0
CIS	10.2	1.8	-13.6	5.9	18.7	-0.6	7.0	5.4	4.7	1.2	-0.5	-3.9
Armenia	55.4	-12.2	8.9	67.1	4.5	18.4	-25.8	-28.1	-27.3	-18.3	-18.8	-21.1
Azerbaijan	-3.1	18.1	-40.1	41.4	-28.6	46.3	-8.8	-1.0	-9.3	-29.2	-23.7	-30.6
Belarus	6.3	1.8	-7.4	25.6	21.2	13.2	-3.5	-7.1	-9.0	-3.8	-6.0	-7.4
Georgia	23.3	45.1	-16.4	78.7	44.1	10.2	-8.2	-10.0	-11.7	-6.6	-7.0	-7.0
Kazakhstan	15.7	28.4	-3.4	12.3	51.9	13.6	6.9	7.0	5.3	-3.6	-4.1	-4.1
Kyrgyzstan	-20.0	154.5	4.7	107.6	-21.9	59.4	-13.4	0.6	-6.3	-23.7	-7.8	-19.1
Republic of Moldova	-9.7	6.0	-14.0	54.5	35.0	20.5	-9.9	-15.6	-29.9	-11.1	-13.9	-23.3
Russian Federation	8.7	-1.2	-14.9	-4.9	23.3	-0.2	8.8	6.7	7.1	2.8	0.8	-2.7
Tajikistan	-11.6	7.7	-16.2	-13.9	-6.2	-7.4	14.6	22.2	6.5	-7.0	-5.4	-4.6
Turkmenistan	-42.1	-45.5	-29.7	49.3	-42.5	-15.7	-17.3	-8.6	-9.7	2.0	-22.2	-25.4
Ukraine	13.4	23.6	-8.0	17.1	12.7	-6.2	1.3	2.8	2.6	-2.7	-2.7	-4.1
Uzbekistan	94.0	-4.4	-13.6	96.0	1.9	-21.5	0.9	-0.5	0.3	-7.1	-3.9	-3.4
Total	**6.7**	**4.7**	**-0.2**	**12.7**	**10.6**	**6.5**	**-0.1**	**-1.4**	**-2.7**	**-0.9**	**-2.2**	**-4.0**

	Merchandise exports in dollars (growth rates)			*Merchandise imports in dollars (growth rates)*			*Trade balances (per cent of GDP)*			*Current account (per cent of GDP)*		
	1996	*1997*	*1998[a]*	*1996*	*1997*	*1998[a]*	*1996*	*1997*	*1998[a]*	*1996*	*1997*	*1998[a]*
Memorandum items												
CETE-5	4.0	6.8	12.7	15.6	6.7	10.7	-8.6	-9.5	-9.1	-3.3	-3.5	-3.3
SETE-7	-0.6	2.5	-1.4	8.7	4.8	3.1	-11.2	-12.4	-11.1	-5.3	-6.8	-5.4

Source: National statistics, Commonwealth of Independent States (CIS) Statistical Committee and direct communications from national statistical offices to Economic Commission for Europe (ECE) secretariat; ECE secretariat computations.

Note: Foreign trade growth is measured in current dollar values. Trade and current account balances are related to GDP at current prices, converted from national currencies at current dollar exchange rates. Trade values include the "new trade" among the successor States of former Czechoslovakia and the former Socialist Federal Republic of Yugoslavia, but not intra-CIS trade. Current-price GDP values are in some cases estimated from reported real growth rates and consumer price indices. On regional aggregates, see the note to table 1.

Two dots (..) indicate data not available; a dash (–) indicates that the amount is nil or negligible.

[a] January–September.

United Nations E/1999/16

Economic and Social Council

Distr.: General
27 April 1999

Original: English

Substantive session of 1999
Geneva, 5–30 July 1999
Item 10 of the provisional agenda
Regional cooperation

Summary of the economic and social situation in Africa, 1998

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99-12137 (E) 190599

I. Introduction

1. The present report reviews the performance of the African region in 1998 from the perspective of the capability of the region to attain the developmental objective of reducing poverty by half by the year 2015. This objective derives from the post-independence commitment of African Governments to improve the standard of living of their people. More recently, a consensus has emerged among African Governments and their development partners that this goal is the overarching objective of development in the continent. The latest articulation of this objective was at the Second Tokyo International Conference on African Development held in October 1998.

II. State of the African economies in 1998

2. For the fourth consecutive year, gross domestic product (GDP) in Africa grew faster than population, contrasting markedly with a decade and a half of declining per capita income. The 3.3 per cent growth in GDP in the region, compared with 2.9 per cent growth in 1997, was the highest in the world.

3. This growth is a very welcome achievement for Africa. However, the level of growth is below that necessary to have a significant impact on poverty. If Africa is to reduce poverty by half over the next decade and a half, it will need to attain and sustain an average growth rate of 7 per cent per annum. This is the major challenge for African policy makers and their development partners.

4. Recent growth of African economies is all the more remarkable considering the declining momentum in global growth. The world economy slowed to 2 per cent growth in 1998, from 4 per cent in 1997. The slowdown in Asia triggered by the East Asian currency crises rippled through the world in three ways. Market economies in emerging countries shrank as Governments pursued restrictive fiscal and monetary policies for curative and protective reasons. Globally, there was reduced demand for exports, and there was downward pressure on commodity prices. In combination, these factors contributed to the reduction of global trade from 6 per cent in 1997 to 2 per cent in 1998.

5. Using continent-wide averages for Africa can be misleading because substantial population and GDP differences exist among the subregions of North Africa, West Africa, Central Africa, East Africa and Southern Africa, and also within subregions. The five biggest economies of the continent (South Africa, Nigeria, Algeria, Egypt and Morocco) account for 37 per cent of the population and 59 per cent of GDP. The 33 least developed countries have 45 per cent of the population and only 17 per cent of GDP. From another perspective, the 11 oil-exporting countries of Algeria, Egypt, the Libyan Arab Jamahiriya, Tunisia, Côte d'Ivoire, Nigeria, Cameroon, Gabon, the Congo, Angola and Equatorial Guinea account for 49 per cent of GDP and 36 per cent of the population.

6. Africa's positive aggregate economic performance in 1998 (3.3 per cent GDP growth, compared with 2.9 per cent in 1997) was not shared evenly across the continent. Only the North and Central African subregions grew in 1998; there were declines in the eastern, western and southern subregional rates of growth. The oil-exporting countries maintained their growth momentum as a group (3.7 per cent in 1998 versus 3.6 per cent the previous year), but growth in Gabon and Angola declined by half, while it increased in the Congo and Algeria. Largely because of the recovery in agriculture and the decline in oil prices, the non-oil-exporting countries grew at a level of 2.9 per cent, up from 2.3 per cent in 1997. It is encouraging that the 33 least developed countries increased their GDP growth rate from 2.4 per cent in 1997 to 4.1 per cent. Growth in the five largest economies (see para. 5 above) increased from 2.2 per cent to 3.1 per cent. Only two economies (the Comoros and the Democratic Republic of the Congo) had negative GDP growth in 1998 compared with four (the Comoros, the Democratic Republic of the Congo, the Congo and Morocco) in 1997. Still, only three countries (Botswana, the Congo and Equatorial Guinea) grew at levels of 7 per cent or more in 1998, the average growth rate required to reduce poverty by half by the year 2015.

7. Agriculture remains the dominant sector in Africa, and its recovery in 1998 fuelled GDP growth. Good weather and reforms, which improved the availability and distribution of modern inputs, including credit, contributed to the better performance. However, the removal of subsidies and the reduction of public extension services, which resulted from the reforms, negatively affected small producers in the agricultural sector. Constraints in the sector were aggravated by the decline in donor support for rural development projects and the reduction of investment in rural social services. These developments had a negative impact on the drive by African countries to attain food self-sufficiency.

8. The industrial sector grew by 3.2 per cent in 1998, down from 3.8 per cent in 1997. The fall in investment was one of the reasons for the drop in growth of the manufacturing subsector, from 2.5 per cent in 1997 to 2.0

per cent in 1998, although weak competitiveness due largely to relatively low productivity were also factors.

9. The recession in emerging markets was transmitted to Africa mainly through depressed commodity prices. All of Africa's exportable products were affected, with oil experiencing the largest fall. But the decline in oil prices did benefit the oil-importing African countries.

10. There was serious pressure on the balance of payments in 1998. Export revenue declined by 17 per cent. For the first time in the decade of the 1990s, the trade balance turned negative, boosting the current account deficit to a high of $16 billion. The perennial imbalance in the services sector, driven by external debt payments and the cost of transport and financial services, continued to put pressure on the current account balance and to claim an inordinate share of foreign revenue from merchandise exports.

11. Resource flows into Africa declined to $3 billion from $4.5 billion in 1997 as a result of reduced private flows and bilateral credit. For sub-Saharan countries, net transfers declined by nearly 40 per cent. The ratio of debt stock to GDP increased moderately and the ratio to exports grew steeply because of the latter's decline. Debt service increased to $35 billion, or 31 per cent of goods and services exports. Ongoing debt reduction initiatives did not significantly affect the debt burden. Only one country of the 41 potentially eligible has benefited from the Heavily Indebted Poor Countries Debt Initiative. That country, Uganda, had its debt reduced by 20 per cent. Only four additional countries (Burkina Faso, Côte d'Ivoire, Mali and Mozambique) are currently scheduled to receive actual debt reduction in the next three years.

12. Investment as a percentage of GDP increased from 21 per cent in 1997 to 23 per cent, mainly because of a 1 per cent increase in domestic savings. Higher incomes and lower consumption, especially in the public sector, were the major contributory factors in the change in domestic savings.

13. Inflation declined from 15 per cent in 1997 to 12 per cent. Increased agricultural production and the fall in the price of imports helped to contain consumer prices. The decline in external trade resulted in an increase in government deficits due to reduced revenues from international trade taxes.

14. Medium-term prospects are brightened by the past four years of increased GDP growth. However, two key determinants of future growth are weather and the external economic environment, which are both exogenously determined. It is unlikely that good weather can be counted on every year although it has occurred for the last four. And the global economy seems unlikely to change for the better over the medium term.

III. Challenge of reducing poverty in Africa

15. Until recently, information to measure the extent and severity of Africa's poverty was inadequate for most countries . The key data used for this purpose are from surveys of household income and expenditure that are time-consuming and expensive to complete. Fortunately, sufficient data now exist for some African countries to make these calculations possible. Data used in the present report are for countries that have 60 per cent of the total population of Africa, and which accounted for 76 per cent of the continent's GDP in 1998.

16. The relevant measure of standard of living is usually taken as the per capita income of society in advanced countries and per capita consumption expenditure (including the consumption of own production) for developing countries. The poverty line can be calculated and the ratio of poor to the total population (the head-count ratio) can be derived. Alternative approaches combine indicators of well-being, such as per capita income, life expectancy, infant mortality and primary school enrolment.

17. Analysis of income distribution in Africa shows a fairly high degree of inequality. Compared with other regions of the world, Africa has the second most unequal income distribution next to Latin America. The Gini coefficient for Africa as a whole is 44.4 per cent. The highest values for inequality are for South Africa, Kenya and Zimbabwe, the lowest for Egypt, Ghana and Algeria. The picture of relatively high inequality is confirmed by shares of total expenditure by quintiles.

18. Although 44 per cent of Africa's population live below the region-wide poverty line of $39 per capita per month, the depth and incidence of poverty varies between and within subregions. In the North Africa subregion, only 22 per cent are under the poverty line of $54 per capita per month, while sub-Saharan Africa has 51 per cent below the poverty line of $34 per capita per month. Significantly more poor people live in the rural areas. The average income of the rural poor is only $14 per person per month, compared with an average of $27 per month for the urban poor.

19. To reduce poverty by half in Africa by the year 2015 will require a 4 per cent reduction in the ratio of people living in poverty each year. Change in poverty can arise for two reasons: a change due to growth in mean consumption

expenditure (appropriately adjusted for the change in the poverty line); and a change in the distribution of income (the inequality measure). For Africa as a whole, GDP growth of about 7 per cent per annum would be required to achieve this annual reduction in poverty. Increases of 5–6 per cent are needed for North Africa and Southern Africa, 6–7 per cent for Central Africa, and 7–8 per cent for the West and East African subregions.

20. For Africa as a whole, investment of 33 per cent of GDP would be needed to reach 7 per cent per annum growth, to be financed partly by domestic savings and the rest by foreign inflows. The current domestic savings rate is about 15 per cent. Thus, a further 18 per cent would be needed from external sources. Official development assistance (ODA) for the continent averages about 9 per cent, which leaves a residual financing gap of about 9 per cent.

21. Africa-wide averages hide large variations among the subregions. North Africa needs only about 5 per cent of GDP in external resources to complete the financing needed to generate a GDP growth rate high enough to halve the poverty level in the subregion by 2015. ODA to the subregion has averaged about 3 per cent of GDP, leaving a financing gap of about 2 per cent of GDP. Financing investment for needed GDP growth is most difficult in Central Africa, where the residual financing gap is about 27 per cent.

22. Recent foreign resource flows to Africa have been far short of the volume needed to meet the poverty reduction objective. Africa must address the key issue of raising domestic savings rates, but in the short run any expectation of significant change is unrealistic in view of the existing low levels of income. Given these rather stark realities, what are the key policy issues for the development of Africa? Clearly, in this globalized world, the international economic environment has an impact on Africa. Commodity prices are beyond the control of African policy makers, and ODA flows and dealing with the debt overhang can be influenced only indirectly by maintaining exemplary domestic economic management. ODA and debt issues require the assistance of Africa's development partners.

23. Policy issues that can be addressed directly by African policy makers relate to domestic savings and external resource inflows other than conventional ODA, such as foreign direct investment, and the causes of capital flight. Stabilization of the macroeconomy will stimulate savings by creating an economic environment where private agents can plan their future with a large measure of confidence. Moreover, prudent government behaviour and fiscal discipline will be expected to contribute to increased savings.

24. Financial liberalization will theoretically lead to higher savings through the effects of high real interest rates on savings. However, most empirical work suggests that the effect of interest rates on gross savings is weak or non-existent. The most important determinant of savings in Africa has been found to be the level of real income. Very poor people save little or nothing, and income must rise above the subsistence level before increases in income result in higher savings. For example, it would take 18 years of 5.3 per cent GDP growth for sub-Saharan Africa to reach the income threshold where further increases result in increased savings rates. More research is needed to advance understanding of the factors determining savings rates in sub-Saharan countries. Current understanding of the linkage between interest rates and savings indicates that African Governments have few policy instruments to increase savings in the medium run and for as long as incomes remain low.

25. Africa has suffered massive capital flight, estimated to total $22 billion between 1982 and 1991. At the end of 1991, the average ratio of capital flight to debt was estimated at over 40 per cent for a sample of 18 countries for which data were available. For four countries, the rate exceeded 60 per cent (Nigeria: 94.5 per cent; Rwanda: 94.3 per cent; Kenya: 74.4 per cent; and the Sudan: 60.5 per cent).

26. A number of former and current top African officials are thought to hold huge foreign currency denominated accounts outside their continent. Most of these assets are believed to be the result of rent-seeking and corrupt activities. Whatever the sources and wherever they are, these resources need to be invested in Africa. A difficult question is what African Governments can do to obtain the repatriation of those funds, and how the countries in which the accounts are held can be persuaded to be of assistance.

27. Foreign direct investment (FDI) is needed as a non-debt-creating form of resource inflow. But experience shows the share of FDI flows to Africa is very small and is highly biased in favour of mineral-rich countries. FDI in Africa seems to be caught in a vicious circle since it requires a hospitable economic environment and sustained high growth. Yet FDI is needed to help create that environment and achieve that rate of growth.

28. The underdeveloped human resource base — exacerbated by outmigration of skilled Africans — and the weak physical infrastructure of the continent deter foreign direct investment. Yet huge investments are needed to develop a skilled labour force and expand transport, communications, energy and related infrastructure. Domestic private sector resources are inadequate to meet these

challenges. Foreign direct investment could help. However, given the large volume of investment needed and the low domestic savings rate, targeted mechanisms and special arrangements may be required to entice FDI into these areas. In addition, strategies need to be devised to increase productivity and make judicious use of whatever domestic and foreign resources Governments can mobilize to enhance investment and growth. African countries will need to deepen and expand their reforms, while making sure that the process supports rather than constrains investment. It is important to recognize that persistently high real interest rates engendered by financial liberalization without sufficient institutional development to foster competition, and exchange rates that do not reflect the true scarcity of foreign exchange or that fluctuate wildly can distort investment incentives and decisions. Similarly, trade liberalization that confers undue advantage on foreign competitors has not been conducive to the expansion of domestic investment in the past.

29. Furthermore, political and civil instability, weak institutional capacity and inefficiencies have not created an investment-friendly climate. These conditions have had important negative implications for resource mobilization and utilization in Africa, including exacerbating capital flight. They will therefore need to be given urgent attention.

IV. Performance and sustainability of African economies

30. In 1998, Africa enjoyed its fourth consecutive year of positive GDP growth despite global financial and currency turmoil. But this favourable outcome cannot be assumed to mean that the aggregate African economy has crossed the critical threshold to a self-sustainable poverty-reducing growth path. For this to be true, the global environment and exogenous shocks would have changed permanently for the better and/or the domestic foundations for sustainable development would have been put into place. Unfortunately, the global environment and exogenous shocks are not changing in Africa's favour. ODA is stagnant or declining, little progress has been made in reducing the debt burden, protectionist tendencies continue in Africa's major markets and erratic weather conditions persist.

31. Current growth theory posits a specific group of variables and factors to constitute economic growth fundamentals. Macroeconomic stability and other steps are needed to reduce transaction costs, raise returns on investment, reduce risks to investors, improve human capital, improve international competitiveness and address the problems of poverty and inequality. To test whether or not Africa has built a critical mass of momentum towards sustained poverty-reducing growth requires the use of multiple evaluation criteria. Unfortunately, comprehensive Africa-specific composite indices needed for this purpose are not available.

32. An effective evaluation process requires a broad and consistent framework that reflects the current and future capabilities and aspirations of Africa's people and the functions and constraints of its Governments. The overall economic role of the State, it is generally agreed, is the sustainable improvement of the well-being of its citizens, which subsumes standard functions relating to economic growth and stability. Human well-being is central to the notion and measurement of economic development. Broadly speaking, economic policies and performances are deemed good if their impact on well-being is both positive and sustainable. More specifically, an evaluative framework should focus on three dimensions — the impact of policies and performance on well-being; the consistency of policies with the desirable and feasible economic functions of the State; and the sustainability of policies and performance.

33. The definition and measurement of well-being can be approached in two ways. First, by using the *constituents* of well-being, such as nutrition levels, educational attainments and life expectancy. The second is by using *determinants* such as income levels and the availability of educational and health services. In practice, the simultaneous use of both criteria is required.

34. Four elements are used to measure the quality of life — income levels, health status, educational attainment and political and civil liberties. Thus, economic development can be viewed as a sustainable and sustained increase in real incomes; improvements in health and educational status; and widening of the freedoms of people.

35. In Africa, one way of summarizing the objective of enhancing well-being, which also translates into the main object of development, is the eradication of poverty. Poverty can be viewed as having two main dimensions -- material poverty (measured in levels of income) and human poverty (measured in terms of health, education and liberties).

36. The consensus is that the State can and should promote economic development, and through it the well-being of its citizens. In a market economy, the basic economic functions of the State include maintaining law and order; ensuring macroeconomic stability and an incentives-compatible microeconomic environment; investing in basic social services (health and education) and infrastructure (transport and communications networks); and protecting vulnerable

people and the environment. To the extent that these functions enlarge the economic space for efficient and effective enterprise and growth, empower citizens to make choices, protect the environment for future generations, and assist the weak and vulnerable in living a meaningful life, they have a positive impact on well-being.

V. State of well-being, 1998

37. The well-being of Africans is measured in terms of income, health, education and freedoms — the four factors mentioned above. For the first three of these, per capita income, life expectancy at birth, infant mortality and adult literacy are the proxies measured and compared using Borda rankings. These are ordinal indices, using country scores that are the sums of the rank that a country obtains according to the level of each of the variables in the welfare index (hence, equal weight is given to each variable). The sum of the rankings for each country in terms of real per capita GDP, life expectancy at birth, infant mortality and adult illiteracy yields the Borda rank. The best performer has the highest scores, the worst the lowest. For the 46 countries with complete data, results are used to rank countries by indices and then to test for correlation among rankings. The focus is on the 10 countries with the highest scores and the 10 with the lowest scores.

38. The countries with the lowest Borda scores (in ascending order, Sierra Leone, Mali, Burundi, Mozambique, Malawi, Ethiopia, the Niger, Chad, the Gambia, Guinea-Bissau, Burkina Faso and Uganda)[1] come from all subregions except North Africa. They are mainly tropical countries with relatively low resource endowment. They include both large and small countries. Eight are landlocked (Malawi, Mali, the Niger Uganda, Ethiopia, Burundi, Burkina Faso and Chad) although the significance of this fact is unclear since there are landlocked countries that have performed well (such as Botswana and Zimbabwe). Most have experienced recent political instability. Although the precise relationship between conflict and low levels of well-being is not quantifiable, past neglect and destruction of assets are probable factors.

39. The highest-scoring countries (in ascending order, Egypt, Gabon, Morocco, Cameroon, Botswana, Swaziland, Algeria, Cape Verde, Tunisia, the Libyan Arab Jamahiriya, South Africa, Mauritius and Seychelles)[1] are predominantly from the North and Southern African subregions. Two of them — Botswana and Swaziland — are landlocked. Population densities are not particularly high. Eight have enjoyed political stability for long periods (all except South Africa and Algeria).

40. The close relationship between income and well-being is confirmed in reference to these two indices. Eight of the 10 best performers selected by per capita income belong to the top 10 countries in the Borda rankings (the exceptions are Cameroon and Swaziland in the Borda top-10 score, replaced in per capita score by Gabon and Namibia). The sets of bottom-10 countries in the two rankings share five countries (Mozambique, Ethiopia, Sierra Leone, Burundi and Malawi). This relationship suggests that citizens of countries with higher per capita incomes are more likely to achieve better well-being. Also, the results suggest that policies targeted primarily at raising incomes can help to improve the overall well-being of communities.

41. With regard to the relationship between well-being and competitiveness, the Borda rankings are compared with the Africa competitiveness index (ACI), which was computed by the World Economic Forum and the Harvard Institute for International Development. ACI consists of a weighted average of six sub-indices covering openness to international trade, the size and role of government, finance, infrastructure, labour and institutions. The positive statistical correlation between the ACI and Borda rankings confirms that welfare and competitiveness move in the same direction. The implication is that policies that enhance the competitiveness of countries are likely to contribute to improving the welfare of their citizens.

42. It is argued that a major determinant of both FDI and capital flight is the risk perception that investors associate with individual countries and groups of related countries. The status of well-being can be expected to relate to investment through the growth-investment link. Several organizations attempt to measure and publish information on investment risk. One such ranking is the institutional investor country risk ratings (IICRR), which covers 35 African countries. A comparison of the 10 countries at the bottom of the Borda and IICRR rankings reveals only two countries in both (Sierra Leone and Mali). Nevertheless, all the bottom-10 IICRR countries for which there are Borda scores are identified as comparatively poor performers by the latter. By contrast, the two rankings share seven top-10 countries (Mauritius, Botswana, Tunisia, South Africa, Egypt, Morocco and Seychelles). It appears that countries with higher IICRR scores are also more likely to achieve better welfare outcomes.

VI. Performance and sustainability

43. A central issue in economic performance and policy evaluation is the question of sustainability, which explains why some African countries labelled "high performers" at one time drop out of the club. Sustainability is defined in terms of three attributes: the consistency of the observed short-run outcomes with stated long-term goals; continuing replicability of observed (positive) outcomes in the future; and laying the foundations for take-off and ensuring a stable acceleration path. In the Economic Commission for Africa (ECA) indices, emphasis is given to key elements of sustainability, including macroeconomic indicators, structural diversification, dependency, transaction costs/competitiveness and human capital development. Outcomes are also affected by non-policy factors, such as the international economic environment, initial resource endowments, external shocks (terms of trade, financial flows, weather), donor preferences and civil political conflicts. Accordingly, the indices used in the present report separate policy and non-policy factors. We plan to refine the indicators further in future reports.

44. Three indicators reported here have been newly created by ECA: the annual performance trend index; the economic sustainability index, and the economic policy stance index.

45. The annual performance trend index (APTI) measures improvement or decline in current account balance, inflation and per capita income (this is only a year-on-year measure). Its results can be presented from two perspectives: country performance, and population benefiting from performance improvements or negatively affected by decline. Thirty-two of the 50 African countries for which data were available experienced some improvement in 1998; only 17 countries were worse off. Yet only the Central and North African subregions experienced significant progress in 1998. Southern Africa was basically unchanged, and the East and West African subregions declined (the latter heavily influenced by Nigeria's performance). Fourteen countries had negative ratings, including five of the 11 oil-exporting countries (Gabon, Libya, Algeria, Angola and Nigeria).

46. It is important to note that 14 of the lowest-scoring countries recently experienced or are currently experiencing some form of civil conflict or social upheaval. From the point of view of shares of the population affected by gains and losses, through cluster analysis APTI paints a mixed picture. For the majority of the population of Africa, there was little if any improvement in economic conditions. This is because a majority of the population lives in countries that score poorly on the index, largely because of negative commodity price developments. The analysis highlights the vulnerability of African economies to exogenous economic and non-economic shocks.

47. To complement the short-term focus of APTI, the economic sustainability index (ESI) has been constructed as a measure of a country's capacity to maintain long-term economic growth. ESI is currently composed of 21 different indicators covering five categories — human capital development, structural diversification, dependency, transaction costs and macroeconomic aspects of sustainability. More indicators will be added in future reports to enhance its utility as an information resource.

48. Using ESI, Equatorial Guinea, South Africa, Botswana, Mauritius and Tunisia are the top five. Notably, three of those countries (South Africa, Botswana and Mauritius) enjoy a high level of resource endowment. Equatorial Guinea, which has enjoyed impressive performance in recent years due to a sudden oil boom, has yet to deepen and broaden its developmental parameters to confirm its capacity for sustainable growth. More data for Equatorial Guinea and Botswana on structural diversity and transaction costs would make the result more robust.

49. The countries at the bottom of the ESI rankings have some history of civil conflict (Sierra Leone, the Niger, Benin, Uganda, the Central African Republic and Rwanda). Subregionally, the Southern and North African subregions rate considerably higher than Central Africa. The East and West African subregions are at the bottom. Over two thirds of the countries are classified as having low sustainability — including large and small countries, natural resource-rich and natural resource-poor countries, countries with good policies and countries with bad policies — and are found in all parts of Africa except the Maghreb.

50. The economic policy stance index (EPSI) measures the appropriateness of government monetary and fiscal policy. Indicators relate to budgets, taxation, monetary growth and interest rates. Incomplete information has limited coverage to only 33 countries. As with ESI, countries are scored from one to 10 based on how they compare with the average of the three best. Ethiopia, Egypt, the Congo, Seychelles and South Africa fill the top five positions in the ranking. With the exception of the Congo, the policy stance of all of these countries also has relatively high approval ratings from the World Bank. No country achieved the best-practice score of seven. The top two countries scored above five (Seychelles and South Africa). In the cluster analysis, however, nearly a third of the countries scored in the cluster associated with good performance, and only a handful of countries rated as poor. This suggests the emphasis on policy reform in recent

years has resulted in significant progress although there is still some distance to go.

VII. Interrelationship between indices

51. Correlation analysis is used to test the connections among the performance, sustainability and policy stance indices. APTI shows little correlation with the other variables, suggesting that an African economy's performance in a given year is not strongly connected to sustainability or well-being. ESI shows a significant degree of correlation between most of the other variables, implying that long-term sustainability is linked to improved standards of living, reduction in poverty, and an environment more conducive to investment. EPSI correlates significantly with the sustainability, well-being, competitiveness and human development indices, suggesting that policy improvements can lead to improvements in these areas as well.

VIII. Some observations on policy implications

52. The pilot application of indices for 1998 has been limited to variables that are quantifiable and for which there are available data. Even this modest effort has yielded interesting results.

53. While four countries (Botswana, Mauritius, South Africa and Equatorial Guinea) score high on the ESI index, only three of them — Botswana, Mauritius and South Africa — satisfy the minimal requirements to sustain growth and development. These countries enjoy a high degree of human capital development, and have fairly well diversified economies and relatively low transactions cost. Equatorial Guinea scores high on the sustainability index despite the non-diversification of the economy mainly due to high macroeconomic indicators of sustainability driven by the oil revenues since the early 1990s.

54. It is of singular importance to underline the fact that an economy's performance in a particular year is not indicative of its overall strength and long-term potential. This is significant for Africa's economies since many of them are prone to exogenous shocks that could have a negative impact on their positive performance from year to year. African countries therefore need to take effective measures to plan for and mitigate the crippling effects of negative natural and environmental phenomena through better scientific and policy understanding and proactive programmes to apply science and technology in solving environmental and natural resource-based constraints. Africa must also come to grips with natural and man-made human catastrophes, particularly the scourge of civil wars and conflict and the human immunodeficiency virus/acquired immunodeficiency syndrome (HIV/AIDS) pandemic, which have undermined the sustainability of development.

55. The frequency with which countries enter and drop out of the list of "high" or "good" performers has been a cause of concern. While policies are very important, they are by no means sufficient to sustain development. The unfortunate neglect of the sustainability variables — macroeconomic factors (savings-investment and exports), human capital, institutions, structural diversification, transaction costs and competitiveness, as well as environmental and ecological balance — must have been the major cause of Africa's fragile economic performance over time.

56. For most of the African countries now on the verge of recovery, the capacity to sustain growth and development over time is very low. The key mistake of the past two decades has been the focus on macroeconomic stabilization while capacity, structural and institutional elements were neglected. Achieving stabilization has entailed sacrificing expenditures needed to build the requisite institutions and infrastructure, and invest in human capital development and retention. Policies with the twin goals of macroeconomic stability and sustainability have either not been drawn up and adopted or are not being implemented. These are the urgent tasks at hand.

57. The analysis and process of constructing the indicators of performance, sustainability and policy stance underscore the many challenges facing decision makers in moving forward with the Africa development agenda — implementing and sustaining macroeconomic reforms; human capital development; diversification of the economy; institutional development; competitiveness and the capacity of the economy to internally generate resources etc. These challenges call for appropriate policy response by Africa's decision makers. While the present report focuses on key indicators of economic performance and sustainability, which have been developed by ECA, subsequent reports will, in addition to further refining the indices, address the key policy challenges for Africa underlying a particular sustainability index component or components thereof. The ultimate objective is to help focus policy advice on longer-term structural issues while responding to the shorter- term issues and measures that have tended to dominate economic policy discourse.

Notes

[1] Tied scores result in more than 10 countries being listed.

United Nations E/1999/17

Economic and Social Council

Distr.: General
14 April 1999

Original: English

Substantive session of 1999
Geneva, 5–30 July 1999
Item 10 of the provisional agenda*
Regional cooperation

Summary of the economic and social survey of Asia and the Pacific, 1999

Executive summary

The economic crisis that began in Asia in 1997 has turned out to be deeper and more long-lasting than had been foreseen. Further, its impact has been widespread, affecting many countries within the region and beyond.

However, declining interest rates, stability in exchange rates and stock markets, improved current account positions, higher foreign exchange reserves and implementation of financial sector reforms should generate mild recovery in the region towards the latter part of 1999, barring any further shocks in the financial markets.

As a result of the economic crisis, a number of countries in the region are experiencing severe social problems. With mounting unemployment, the incidence of poverty has increased. The availability or utilization of essential health and education services has been reduced. The ability of Governments to address these problems has been constrained by reduced revenue collection and, in some cases, by the budgetary targets envisaged under the bailout packages.

Policies at the national, regional and international levels are needed to overcome the problems created by the economic crisis. The prevailing credit crunch has to be overcome, the financial sector strengthened and the corporate sector restructured. Consideration needs to be given to reforming the international financial architecture and intensifying regional cooperation, including consideration of the establishment of an Asian Fund.

* E/1999/2

99-10650 (E) 020699

Governments have to play a critical role in ensuring social protection. With that end in view, budgetary allocations for the social sector have to be preserved and augmented. Among other measures suggested are the establishment of a "social fund"; proper targeting of publicly provided goods and services; strengthening of institutional capacity and the information base; involvement of all stakeholders in the design, implementation, monitoring and evaluation of programmes; unemployment insurance schemes; and strengthening of the rural and urban informal sectors.

The expanding range of applications of information and communication technology (ICT), which help to increase the efficiency and flexibility of production, marketing, financial and administrative activities for both the private and the public sectors, presents a new multifaceted challenge for Governments. These applications offer enormous opportunities to enhance the competitiveness of industry, increase the returns from trade, attract foreign direct investment and other forms of external capital, increase the integration of small and medium-sized enterprises into the value chain, and enhance the service provided by the financial sector. There is a very significant threat that countries which do not enter actively into the information age will be increasingly marginalized in the twenty-first century. However, the use of ICT also magnifies the risk of loss of control over a country's economic destiny. Domestic economic policies are forced to become aligned with international ones and trade and investment decisions by both domestic and foreign terms are taken in line with considerations of global competitiveness, which may not always be consistent with national interests.

Because the policy framework enabling a country to become an active participant in information technology is multidisciplinary and involves many ministries, it is complex to formulate and implement. The basic requirement is to create a conducive environment for the development of ICT infrastructure and to promote the training of appropriately skilled human resources. The framework also has to include policies for trade (electronic commerce), production and finance, complemented by modern legal and regulatory systems able to handle electronic contracts. Given the wide range of application of ICT, representatives of various private sector groups need to be involved in the articulation of policy frameworks. In many cases, a Government itself could benefit from increased application of ICT within its own administration. A Government can also assist the private sector with demonstration projects.

In order to maximize the benefits of ICT for developing countries and to minimize associated threats, there is an urgent need to negotiate international agreements on the legal/regulatory architecture for electronic commerce, Internet banking and trading of securities, as well as the setting of standards for connectivity and the interoperability of systems. Developing countries can benefit significantly from the technical assistance programmes offered by international and regional agencies, including those of the United Nations.

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I. Recent economic performance and problems

A. Global economic developments and immediate prospects for the ESCAP region

1. After a growth rate of 3.2 per cent in 1997, the world economy slowed sharply to a rate of 1.7 per cent in 1998. World trade growth in volume terms declined even more precipitately, from 9.7 per cent in 1997 to 3.7 per cent in 1998, while the flow of private finance to developing countries fell in 1998 to about half its level of 1996 and is about 35 per cent less than in 1997.

2. The largest decline was in commercial bank lending. There was also a steep decline in the provision of finance by non-bank creditors and in portfolio equity flows. Flows of foreign direct investment (FDI), however, are estimated to have risen marginally.

3. A number of developments in the world economy have adverse implications for the ESCAP region. The Japanese economy remains weak. Although the economy of the United States of America displays remarkable strength, capital spending, manufacturing growth and exports are tapering off and the current account deficit has begun to widen. In the European Union, growth is tending to slow. On balance, therefore, developed country markets will not be a source of strong demand for exports from the region.

4. A major uncertainty also lies in the behaviour of capital flows. The extent to which confidence was undermined in 1998 and the general risk aversion evident in the developed countries do not suggest that non-FDI private capital is likely to start flowing into the region soon on any substantial scale. The recent trends also suggest that FDI flows may remain concentrated in acquisitions of existing assets, rather than creating new production capacity.

B. Developments in ESCAP developing countries

5. There have been some positive developments within the ESCAP region since the onset of the crisis. These include a downward trend in interest rates, recovery and stabilization in exchange rates and stock markets, and increase in foreign exchange reserves. There are, however, concerns regarding the sustainability of these improvements in the light of only limited progress in financial sector restructuring, the continued credit crunch, the still-growing burden of non-performing loans and no major recovery of exports. On balance, it is likely that the region will experience only marginally better growth performance in 1999 compared with its dismal record in the preceding year (see annex).

6. For South-East Asia, 1998 was perhaps one of the worst years on record. There were large contractions in GDP in several countries, such as Indonesia, Malaysia and Thailand, while GDP growth remained virtually flat in the Philippines and Singapore. Barring Indonesia, inflation rates remained within single digits. Domestic interest rates began to ease significantly. The current accounts of all countries in South-East Asia registered major improvements. This turnaround was largely due to a collapse in imports rather than expansion in exports.

7. In East and North-East Asia, Hong Kong, China and the Republic of Korea experienced large contractions in output. China's growth rate was slightly reduced. Exports from this subregion remained weak and imports fell sharply. Consistent with slower growth, rising uncertainty and demand compression, inflationary pressure in these economies receded. An extreme case was China, where a massive build-up of inventories generated deflationary pressure, and in 1998 prices fell slightly.

8. In the economies of South and South-West Asia, the relative insulation of the financial markets moderated the contagion effect of the regional economic crisis on the domestic economy. In the Islamic Republic of Iran, GDP contracted in 1998 owing to the slump in oil prices. GDP growth rates in other countries remained moderately high. Inflation rates in the countries of the subregion were either lower, or increased very slightly, in 1998 as compared with 1997.

9. Among the least developed countries, growth was much less robust in South-East Asia than in the South Asian least developed countries. One reason was that FDI flows to these countries slowed as investors from Malaysia, Singapore and Thailand either delayed or cancelled proposed projects. Inflationary pressure increased owing to depreciation of their currencies.

10. Except for Papua New Guinea and Solomon Islands, which have substantial trading links with developing Asian countries, and, to a lesser extent, Fiji, the crisis did not have a direct impact on the Pacific island economies. However, many of them were affected indirectly because of the impact of the crisis on Japan and New Zealand, which together absorb a sizeable portion of Pacific island country exports.

11. Central Asian countries recorded positive growth for the first time in 1998. The Russian Federation was the sole economy from North and Central Asia that experienced a serious economic downturn in 1998. A combination of falling output, sharply lower export earnings and government revenues and accelerating inflation undermined the fragile macroeconomic stability achieved by that economy in 1997. The debt freeze severely undermined investor confidence.

C. Policy issues

12. The stubborn persistence of the crisis that engulfed several countries in the second half of 1997 remains the most dominant feature of the economic landscape of the Asian and Pacific region. An indication of the depth of the crisis is given by the fact that developing economies of the ESCAP region as a group recorded a growth rate of close to zero per cent in 1998 as against over 7 per cent in 1996 and almost 6 per cent in 1997. The dismal performance cut across practically all the subregions, with South Asia being the only bright exception. The seriousness of the crisis has prompted considerable reflection on policy measures to prevent such occurrences in the future at the national, international and regional levels.

National level

13. At the national level, there is general agreement that countries need to be more circumspect with regard to the speed and sequence of opening their capital accounts. Those with open capital accounts need to implement their monetary, fiscal and exchange rate regimes much more flexibly. Other issues that have to be dealt with are the institutional arrangements for financial sector supervision, enactment and enforcement of appropriate legislation and rules of behaviour by private business in both the financial and real sectors, and transparency in corporate governance.

14. Economic recovery is the overwhelming challenge facing the region, especially the crisis countries of East and South-East Asia. Strengthening the financial sector is a central issue in this context, with bad debts, recapitalization of banks, high, albeit falling, costs of financial intermediation and the persistent credit crunch in most of these countries tending to hold up recovery. Large-scale public resources will be needed to solve the problem of non-performing loans.

15. In the South Asian countries, the slowness in achieving greater depth in financial markets has been an impediment in diversifying the sources of finance for development. The achievement of higher GDP growth rates has also been constrained by inadequate infrastructure, low productivity and inefficiency in public sector enterprises. Fiscal improvement is another issue with which most of the countries of the South and South-West Asian regions have been grappling with little success.

16. For the least developed countries, poverty alleviation continues to be the major challenge. To break through the poverty syndrome, the existing pace of GDP growth needs to be accelerated significantly. A pertinent policy issue for these countries is how the quality and effectiveness of official development assistance on which they are dependent, can be enhanced.

17. The Pacific island countries face policy issues similar to those of the least developed countries. In addition to the pursuit of higher economic growth, these countries face a daunting challenge in balancing the need for the conservation of resources against exploitation to satisfy their current needs.

18. In North and Central Asia as a whole, the banking sector is underdeveloped and fragile. As a result, it has been unable to provide attractive savings facilities or engage in meaningful intermediation between savers and investors. There is an ongoing need to strengthen banking regulation and supervision.

19. In the Russian Federation, the immediate challenge is to draw up a credible economic recovery plan and to restore confidence in the banking system so as to enable banks to resume intermediation and help in reinvigorating the economy. In addition, improving the Government's fiscal performance remains a major issue.

International level

20. At the international level, strong consideration needs to be given to reform of the international financial architecture. Three areas require attention.

21. First, urgent action is required for prompt and adequate provision of liquidity for pre-empting any major crises, minimizing contagion and mitigating their adverse impact. Hence the need for the establishment of a true international "lender of last resort".

22. Second, in view of the increased frequency and intensity of the crises, caused to a large extent by massive capital movements, a new overseeing body for international capital to be called the World Financial Organization, with

a specific mandate dealing with the monitoring of all short-term cross-border flows, is needed to develop a rule-based system for overseeing, and eventually regulating, international capital flows.

23. Third, it is important that a set of principles be agreed upon internationally for resolving issues related to debt workouts. The proposed World Financial Organization could provide the institutional framework for achieving such agreement.

Regional level

24. There is a strong case for greater regional cooperation in the ESCAP region in such areas as financial sector regulation, the establishment of common prudential standards and the development of early warning systems. The proposal for the establishment of an Asian Fund also merits serious examination.

II. Social impact of the economic crisis

A. Selected aspects of the social impact

The impact

25. The economic crisis in East and South-East Asia has transformed itself into a social crisis, particularly visible in such forms as rapidly rising unemployment, the mounting incidence of poverty and deterioration in health and educational services. The countries most affected in this regard are Indonesia, Malaysia, the Republic of Korea and Thailand.

26. The mounting unemployment and erosion of real incomes have brought about a sharp increase in poverty. It is estimated that, by the middle of 1998, the proportion of poor people in Indonesia had swelled to 40 per cent from only 11 per cent in 1997. In Malaysia, poverty was estimated to have risen from 6.8 per cent in 1997 to 8 per cent in 1998. In Thailand, the incidence of poverty had increased from 11.4 per cent in 1996 to 15.3 per cent in 1998.

27. The sharp decline in incomes has had a negative impact on the consumption of health and educational services. Urgent curative care has been given preference, to the comparative neglect of preventive services. Demand for the less expensive Government-provided services has replaced that for the relatively expensive and better-quality services provided by the private sector. At the same time, the public sector's ability to cope with the increased demand for its services has been constrained by the limited budgetary resources available. For many in the impoverished groups, the education of children is no longer affordable, leading to drop-outs at all educational levels.

Responses to the crisis

28. Governments of the affected countries have implemented programmes and policies to arrest the rapidly deteriorating social conditions. In Indonesia, a major social safety-net programme has been initiated. The Government of Malaysia has introduced several measures to arrest the decline in social welfare arising from the economic crisis. The Government of the Republic of Korea has set up a comprehensive unemployment benefits package, including an expanded unemployment insurance system, a subsidized loan programme for the unemployed and for small-scale businesses and public works programmes. Thailand has launched a social investment project to provide the poor with comprehensive assistance in the form of creation of employment and provision of training as well as capital.

B. Major policy recommendations

29. Governments have to play a critical role in ensuring social protection. The following suggestions are offered for consideration by Governments:

(a) Budgetary allocations for social services should be preserved or, if possible, augmented;

(b) Governments may wish to establish a formal "social fund" in order to provide those who slide into extreme poverty with minimum income support;

(c) There should be careful targeting of measures initiated by Governments;

(d) The institutional capacity and information base required to design and implement targeted projects must be strengthened;

(e) The involvement of local governments, non-governmental organizations, other civil society organizations and beneficiaries needs to be secured in the design, implementation, monitoring and evaluation of programmes;

(f) Serious consideration should be given to the introduction of an effective system of unemployment insurance;

(g) The role of the rural sector as well as the urban informal sector as a cushion should be reinforced;

(h) Governments need to review their development strategies seriously and ensure microeconomic efficiency in order to minimize vulnerability to crises in the future.

III. Globalization, information technology and development

A. Information and communication technology and globalization

30. A hallmark of the closing years of the twentieth century is the marked intensification of the process of globalization. The rapid spread of the use of information and communication technology (ICT) is both an outcome and a determinant of this process, which has manifested itself in accelerated movement of goods, services, factors of production and technology across national boundaries. While there are many positive outcomes from the continuing improvements in ICT, there are also escalating risks associated with its use.

31. ICT is a generic term covering computers, broadcasting, telecommunications, data networks and smart components which are being increasingly applied in diverse uses. It consists of computer systems, data communication systems, knowledge systems, office systems and consumer electronics. As new forms of ICT function interdependently, the assembly of ICT is an intelligent information network. This is leading to the information superhighway, of which the Internet is an example, which provides connectivity for any conceivable transaction, including trading, banking and financial transactions, organization of production, delivery of services such as airline tickets, books and newspapers, software and music compact discs, and home shopping.

32. Economic globalization arises out of the interaction between market- and technology-related factors as well as economic policies at the national and international levels. Market-related factors include increased competition for resources and in the production of the same goods and services, greater engagement in international trade and enhanced efforts to attract foreign direct investment (FDI). These have all been assisted by technological and information-related improvements.

33. In terms of technology-related factors, the componentization of production, facilitated by advancements in both manufacturing technologies and ICT, has led to lower costs, the dramatic shortening of economic distances and fewer distinct markets.

B. Potential benefits to developing countries from applications of information and communication technology

34. There are four dimensions of the positive impact of ICT on economic growth. First, ICT allows process innovation (new ways of doing old things), which increases productivity and creates new value added. Second, innovative economic activities (new ways of doing new things) may be generated. Third, ICT represents a new factor of production, along with land, labour and capital, which can lead to economic restructuring. Finally, it represents a new means of organizing activities through its synergies with other technologies.

35. Some new applications of ICT have made it possible to carry out production and service activities efficiently on a small scale. Advances in telecommunications enable enterprises that are geographically separated to communicate both within a country and across borders. The growing decentralization and globalization of many industries provide new opportunities for developing countries and small and medium-sized enterprises within them to participate in regional and global economic ventures.

36. New applications of ICT are profoundly changing the service sector. In particular, the nature and structure of financial, insurance, marketing, distribution and tourism and travel businesses have been transformed by the improvements in the speed, reliability and cost of manipulating vast quantities of information related to financial, inventory and sales transactions. At the same time, providers of services, traditionally small and decentralized, are being linked nationally and globally through the use of communication technology.

37. The application of ICT is being used to improve the economic efficiency of the banking and financial sector, both to provide clients with services more conveniently and rapidly and to permit financial intermediaries to evaluate more correctly the investment preferences of savers. ICT is also integral to a better regulatory system of financial institutions and financial markets, reducing the possibilities for fraud and enhancing credit-risk assessment and supervisory functions.

38. In the medium term, there is the potential for enormous economic benefits from a broader and more integrated use of ICT in socio-economic development. The potential is, however, crucially dependent on the capacity to disperse ICT capabilities across a broad range of economic activities and income groups.

IV. Applications of information and communication technology in the areas of production, trade and finance

A. Status of application in developing countries of the ESCAP region and constraints on wider application

39. Within the ESCAP region, which has witnessed high growth in investment in ICT in the 1990s, there are very significant variations in its diffusion. Much more progress in making ICT applications accessible to economic actors has occurred in the newly industrializing economies and the members of the Association of South-East Asian Nations (ASEAN) and in some other larger countries, including China and India. In practically all countries, there is still very limited accessibility of ICT components, such as cellular phones and Internet connections, to large segments of the population outside urban areas and to lower-income groups.

40. In the area of production, there has been considerable diffusion of productive units of transnational corporations throughout the region, particularly in the newly industrializing economies and the members of ASEAN and more recently in China, which use ICT to take advantage of country differences in factors of production.

41. A number of countries have developed strategies to attract investment for the development, production and application of ICT in the twenty-first century. These plans emphasize creating a competitive foundation for the future development of information infrastructure.

42. In the area of trade, the most progress in the region has been in the automation of customs procedures, applying electronic data interchange processes to exports and imports, with several countries undertaking projects to simplify and harmonize customs procedures, put them on the Internet and connect them with transport and other logistical procedures. There has also been increasing use of ICT for the promotion of trade and investment, involving applications to match trade and investment opportunities, especially for small and medium-sized enterprises; advertising over the Internet and producing electronic catalogues. There have been a few fledgling initiatives in the area of Internet commerce.

43. In the area of finance, the computerization of banks in the ESCAP region has been fairly extensive and is continuing to deepen to enhance customer service, save on costs and improve credit assessment procedures.

44. The more developed securities exchanges in the region are increasingly using electronic trading systems with "floorless" markets. The recent volatility in stock prices in the region has led many exchanges and their regulatory authorities to take a new look at the rules governing supervision of trading.

45. Central banks and monetary authorities have been increasing the use of ICT in undertaking the supervisory functions for the domestic financial system in terms of reporting mechanisms and information flows. The financial crisis in Asia has stimulated them to take this further and are widening the scope of monitoring to include the flows of investment funds in and out of the country.

46. There are several constraints facing developing countries which affect the spread of applications of ICT. Many of the applications are of very recent origin and it will take some time for them to be absorbed by potential users and by regulators. Further, the technologies and possible applications are changing rapidly, which makes it difficult to keep up, especially in less developed economies. There are frequently problems associated with connectivity. These involve lack of infrastructure, problems with its reliability and relatively high costs of access.

47. There are limitations arising from the underdeveloped state of markets for electronic equipment, both hardware and software — either very limited availability of products or a lack of competition. There are also problems associated with a scarcity of appropriately skilled personnel to handle the operations. There are constraints connected also with limitations of existing legal systems that were not designed to cope with ICT-based processes.

B. Risks to economic security associated with applications of information and communication technology

48. The issue whether the increasing application of ICT threatens the economic security of countries, particularly developing countries, is a serious one. There are new vulnerabilities facing domestic industries in an ICT-intensive world, three of which appear to be of immediate concern. First, as the position of foreign corporations in the production structures of many industries is likely to become more pervasive, there is a risk that it will be more difficult to stimulate the development of local entrepreneurship. Second, there are balance-of-payments risks in that the inflows of capital through FDI or other forms do not necessarily match outflows of remittances of various sorts,

and there are likely to be periods of unanticipated deficits on the capital account, and sometimes even prolonged deficits. Third, the use of ICT means that production units become more footloose and a Government cannot count on the presence of a transnational corporation or even its domestic firms over the longer term as part of its development strategy unless it maintains the locational attractiveness of its economy.

49. In the financial area there are significant risks that, unless the financial sectors and institutions in a country are modernized and supervised in a fashion that takes into account the applications of ICT that allow funds to flow freely around the world, these sectors will continue to be illiquid and volatile.

50. The broad challenge for Governments is to facilitate a new balance between an ICT-dominated global market and local societies: one that will continue to unleash the creative energies of private entrepreneurship without eroding the social basis of cooperation. As ICT is a crucial parameter in this emerging paradigm, it is important that there be an understanding that countries, economies, enterprises and individuals will in fact be more threatened and marginalized by non-participation in the diffusion of ICT than by active participation in its development and its varied applications. ICT is a tool; it is not a threat in itself, but its application will determine whether it is an advantage or a problem.

V. Policy issues

A. National level

51. The experiences of countries to date indicate that obstacles to becoming an active adopter of ICT and a vigorous participant in the ICT era can be attributed to problems in learning processes, social and cultural barriers, policy-related or institutional limitations, including the legal/regulatory environment, and market imperfections. ICT policies are necessarily multidisciplinary and cut across several ministries. Thus, policy frameworks should clearly set priorities, promote training for the related human skills, improve the conditions of access, develop the infrastructure and construct an appropriate legal basis for operation.

52. It is important that progress in the application of ICT be driven by needs and national priorities, not by the technology itself. In policy development, therefore, there needs to be active participation by different user groups to incorporate their specific requirements and circumstances in the national information network.

53. National policies in the trade area that are crucial include the adoption of electronic data interchange modalities to speed up and simplify customs clearance; to initiate steps towards seamless integrated trade transactions; to use ICT to assist with trade and investment promotion, especially for small and medium-sized enterprises; to develop pilot Internet commerce programmes and to work on making the necessary changes or additions to laws and regulations. National policies in the financial sector include the encouragement of more intensive and wider use of ICT for customer services provided by banks, computerization and linking of offices of banks and interbank operations and development of ICT-based monitoring and reporting mechanisms.

B. International and regional levels

54. There is a need for an international policy framework to provide, *inter alia*, universally accepted codes of conduct, so that the use of ICT can be supportive of the development efforts of developing countries. The framework has to cover both competition and coordination, include the broad issues of trans-border data flows, international trade in information services, standards of both a technical and a regulatory nature, access to information technology know-how and markets, intellectual property rights, and donor coordination in ICT-related assistance. It has to address problems of trade barriers and inadequate internationally accepted legal structures as well as problems with the global technical infrastructure.

55. In terms of areas of cooperation, one of the most important is coordination of standards and regulations on the use of the Internet. Without agreements in these areas, connectivity between countries and inter-operability among systems cannot be assured. Cooperation is also important in the area of transparency and trans-border data flows so that access to information is not blocked at national borders.

56. A proposal for addressing the volatility and uncertainty in country-level financial markets, given their lack of breadth and depth, is to develop a regional integrated electronic financial market that can provide a sufficient volume of business and number of listings, among other things, to counterbalance, at least partially, the power of institutional investors.

57. Regional cooperation holds promise in several other areas, such as common training facilities; standards for the interoperability issue; infrastructure; legal approaches; and regional software development for common problems or languages. There is scope for regional efforts in developing

cooperation in technology capability, transfer and innovation and exchange of experience.

58. Of particular importance to developing countries is the issue of access to ICT. Developing countries have to take an active role in the World Trade Organization negotiations on trade in information services and to be well briefed on the possible implications of the decisions for their own development efforts.

59. International and regional agencies have an important role to play as advisers, referees or supervisors in assisting developing countries. As advisers, they can help in articulating interests and concerns in various international forums and in shaping national responses to these issues. As referees, they can provide information and influence to strengthen the negotiating capabilities of developing countries in technology acquisition in a supplier-dominated market. In addition, international agencies can be assigned the role of international supervisors and enforcers of agreed codes of conduct.

Annex

Rates of economic growth and inflation in selected economies of the ESCAP region, 1997–2001

(Percentage)

	Real GDP					Inflation a/				
	1997	1998b/	1999c/	2000c/	2001c/	1997	1998b/	1999c/	2000c/	2001c/
Developing economies of the ESCAP region d/	5.8	0.2	3.6	5.0	5.6	5.7	10.9	6.0	5.2	4.7
South and South-West Asia e/	4.6	5.3	5.6	6.6	6.9	10.5	13.2	11.5	10.4	..
Bangladesh	5.9	5.6	3.3	6.8	7.6	2.5	7.0	8.5	7.0	6.0
Bhutan	6.6	5.0	7.0	8.1	6.1	7.0	8.0	7.6	7.4	7.2
India	5.1	6.0	6.8	7.3	7.5	6.8	12.0	9.0	7.5	6.0
Iran (Islamic Republic of)	2.5	-0.3	0.6	2.8	2.7	17.3	20.3	25.0	30.0	..
Nepal	3.8	2.1	4.5	4.5	..	7.8	4.0	7.0	7.0	..
Pakistan	1.3	5.4	4.0	6.0	6.0	11.8	7.8	7.0	6.0	6.0
Sri Lanka	6.4	5.5	5.7	6.0	6.5	9.6	10.0	9.5	8.5	7.0
Turkey	7.5	4.5	4.2	3.5	7.2	85.7	57.6	53.0	46.6	43.7
South-East Asia	4.3	-6.2	0.4	2.2	3.6	7.9	27.4	10.3	9.0	..
Indonesia	4.7	-14.0	-2.2	0.0	2.5	11.6	80.0	20.0	15.0	10.0
Malaysia	7.8	-6.0	1.0	3.5	4.8	2.7	5.2	3.5	5.5	..
Myanmar	4.6	1.1	2.7	3.0	..	29.7	40.0	35.0	30.0	..
Philippines	5.2	-0.5	2.6	4.1	4.3	5.1	9.0	8.5	6.5	6.0
Singapore	7.8	1.3	0.5	2.4	4.0	2.0	-0.3	2.2	2.4	2.4
Thailand	-0.4	-7.8	0.9	2.5	3.6	5.6	8.2	3.0	4.0	4.0
Viet Nam	8.8	5.8	4.6	6.1	..	3.6	8.2	11.5	10.0	..
East and North-East Asia	7.0	1.5	4.4	5.7	6.0	4.4	3.3	3.2	2.9	3.3
China	8.8	7.8	7.0	7.6	7.3	2.8	-0.8	1.8	2.3	2.9
Hong Kong, China	5.2	-5.0	-0.5	3.3	3.7	5.7	2.6	4.1	4.3	4.3
Republic of Korea	5.5	-6.0	2.0	3.9	5.0	4.4	7.5	3.1	3.7	3.7
Taiwan Province of China	6.8	4.7	5.5	6.0	6.2	0.9	1.9	1.7	2.3	2.8
Pacific island economies	-3.7	-0.2	5.6	5.1	4.1	3.8	8.9	5.6	5.5	5.5
Fiji	-1.8	-3.9	4.5	5.5	4.5	3.4	5.4	5.0	3.0	3.0
Papua New Guinea	-5.2	1.5	6.0	5.0	4.0	3.9	11.0	6.0	7.0	7.0
Solomon Islands	0.1	-2.8	11.5	6.0	5.0	8.1	16.0	9.0	7.0	6.0
Tonga	-1.2	-0.5	4.5	3.0	3.0	2.1	3.5	3.0	2.0	2.0
Vanuatu	2.3	3.7	3.0	3.5	3.5	1.3	-1.0	3.0	2.0	2.0

Developed economies of the ESCAP region	1.0	-2.2	-0.8	1.7	2.0	1.6	0.3	-0.3	0.9	1.3
Australia	2.8	4.5	2.0	2.4	1.7	0.2	0.3	2.6	2.2	2.6
Japan	0.9	-2.7	-1.0	1.6	2.0	1.7	0.3	-0.5	0.8	1.2
New Zealand	3.2	0.2	1.0	3.6	3.3	1.1	1.5	1.5	1.3	1.1

Sources: ESCAP, based on International Monetary Fund, International Financial Statistics, vol. LI, No. 9 (September 1998); Asian Development Bank, Key Indicators of Developing Asian and Pacific Countries 1998 (Oxford University Press, 1998) and Asian Development Outlook 1998 (Oxford University Press, 1998); United Nations, Project LINK World Outlook: Countries and Regions, 30 November 1998; and The Economist Intelligence Unit, Country Reports: Myanmar (Burma); Iran; and South Korea and North Korea, 4th quarter 1998; and national sources.

a/ Referring to changes in the consumer price index.

b/ Estimates.

c/ Forecast/target.

d/ Based on data for 24 developing economies representing about 95 per cent of the population of the region (excluding the Central Asian republics); GDP at market prices in the United States dollars in 1995 has been used as weights to calculate the regional and subregional growth rates.

e/ The estimates and forecasts for countries relate to fiscal years defined as follows: fiscal year 1998/99 = 1998 for Bhutan, India and the Islamic Republic of Iran; fiscal year 1997/98 = 1998 for Bangladesh, Nepal and Pakistan.

United Nations E/1999/18

Economic and Social Council

Distr.: General
15 April 1999

Original: English

Substantive session of 1999
Geneva, 5–30 July 1999
Item 10 of the provisional agenda
Regional cooperation

Summary of the economic survey of Latin America and the Caribbean, 1998

Executive summary

The Latin American and Caribbean region will remember 1998 as one of the most problematic years of recent times. The severe effects of the international financial crisis that broke out in Asia in mid-1997 restricted the region's access to external financing. Tumbling export prices translated into the first drop in the value of the countries' exports to be recorded so far this decade, and this in turn led to a further deterioration in the balance-of-payments current account. Faced with this bleak outlook on the external front, economic authorities displayed a strong determination to confront the crisis head on and build confidence by applying no-nonsense monetary, fiscal and exchange-rate policies.

The year's events also included adverse weather conditions on a perhaps unrivalled scale. First there was El Niño, which affected the entire region. Then came a series of hurricanes that ravaged a number of Central American and Caribbean countries. Despite these upheavals, the economies of Latin America and the Caribbean did fairly well, especially considering the fact that macroeconomic policy was primarily focused on achieving and maintaining stability. Nonetheless, the average growth rate for the region was halved, falling from 5.5 to 2.2 per cent, and the prospects for 1999 are sombre. Unemployment rose, although moderately, while the region's average inflation rate levelled off at slightly over 10 per cent. Prudent policy management enabled the region to avoid, at least during the year, the turbulent sorts of exchange-rate adjustments experienced by some of the emerging Asian economies in 1997 and by the Russian Federation in 1998. But the turbulence witnessed during the first months of 1999 demonstrates that all the virtues of the decade's structural reforms and macroeconomic policy measures notwithstanding, the region needs to make further progress in reducing its external vulnerability.

99-10817 (E) 070599

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I. Introduction

1. In 1998, the Latin American and Caribbean countries had to deal with an extremely high degree of volatility in international finance and trade. Considering the strength of the negative external shocks that dampened growth and seriously hampered the management of fiscal and external accounts, the region's economies performed reasonably well, at least up to the fourth quarter. This volatility is still in evidence, however, and many of these shocks have a delayed effect. Consequently, the outlook for 1999 remains highly problematic.

2. The average growth rate was down sharply, from 5.5 per cent in 1997 to 2.2 per cent in 1998, but even so was higher than the average for the world economy as a whole (1.7 per cent). These figures are annual averages, however, and therefore do not reflect the intensification of economic problems that occurred as the year drew on. The typical pattern in most cases was high growth rates during the first six months, owing to the momentum of the 1997 economic expansion, but very slow growth or even contractions during the last two quarters. Employment figures followed a similar trajectory, with the regional unemployment rate holding fairly steady during the first half of the year but climbing during the second. The strongest aspect of the region's performance was in the area of inflation, which has levelled off at about 10 per cent during the past two years, the lowest rate since 1949. The current account deficit widened substantially, jumping from US$ 64 billion in 1997 to US$ 83 billion in 1998, at the same time that capital inflows dropped from US$ 80 billion to US$ 62 billion. Thanks to the region's high level of international reserves, however, it was able to cover its overall US$ 21 billion balance-of-payments deficit, most of which was accounted for by Brazil. It is important to note, however, that the decrease was due to reductions in short-term capital and that long-term capital inflows were nearly as high as their 1997 record level.

3. Interestingly, the types of problems that were experienced in 1998 and their implications differed significantly across subregions. For reasons that varied from one country to the next, South America was especially hard hit. In most cases, these countries' export prices were sharply lower, and in Chile and Peru the effects of this downswing were compounded by the loss of Asian markets. Another factor within the financial market was that a number of these countries (especially Brazil and Argentina) have well-developed stock markets that provide a vulnerable flank for international volatility. In addition, the spillover from the troubled Brazilian economy has been especially forceful in the Southern Cone.

4. In contrast, Mexico and most of Central America were able to take advantage of the booming United States economy to increase the volume of their exports to that country. Furthermore, in a departure from the trend for the region as a whole, which registered a deterioration in its imports/exports price ratio, the terms of trade of most of the Central American nations were better than they had been in 1997. Although various Central American and Caribbean countries sustained severe damage as a result of the hurricanes that ravaged the subregion in the closing months of the year, the brunt of these storms' economic impact will not be felt until later. Mexico was also hurt by the year's financial shocks, but thanks to its geographic location in the northern hemisphere, its economy turned in a somewhat better growth performance than the South American countries did. Many Caribbean economies registered another mediocre year, as average growth for this subregion was just over 1 per cent.

5. The first quarter of 1999 was overshadowed by the worsening regional situation, when the devaluation of the Brazilian real in January sent shock waves to all the Latin American currency markets. This all demonstrates that even though the region weathered the international crisis fairly well during 1998, the depth of the problems facing Latin America and the Caribbean should not be underestimated. The region's external vulnerability, about which the Economic Commission for Latin America and the Caribbean (ECLAC) has expressed increasing concern in recent years, continues to manifest itself in both the trade and financial spheres. Export prices remain very low, and the possibility that reserves may fail to rebound cannot be ruled out. The cost of financing countries' growing current account deficits is very high since the spreads over industrialized countries' interest rates for bond issues have widened by several points, while stock quotations have tumbled.

6. At the same time, Governments face difficult decisions in connection with their macroeconomic goals. They must choose between raising interest rates in order to protect their exchange rates and guard against any setbacks in terms of inflation, thus slowing the growth of output and employment, or devaluing the currency in order to maintain international competitiveness, which heightens the risk of inflation and adds to the external debt-service burden, and may also drive down real wages. In practice, so far the majority of the Governments have chosen to follow the first option, at least as long as exchange markets can be convinced of the sustainability of this strategy.

7. Projections for 1999 suggest that the difficulties of the second semester of 1998 are likely to continue, at least into the first half of the new year. Austerity measures to deal with

deficits on the fiscal and/or external accounts will leave little room for expansion, although those Governments that opt for large devaluations — with all the risks that they imply — may be able to stimulate their economies through increased exports. Overall, ECLAC estimates suggest that growth for the year will be negative, while inflation should remain in single digits in the majority of the countries.

II. Macroeconomic policy

8. The general orientation of macroeconomic policy in 1998 was towards renewed austerity. There were at least two reasons for this. First, there were the effects of the Asian crisis and its intensification in the second half of the year after the Russian Federation devalued the rouble and declared a partial moratorium on its foreign debt. Faced with investors' newly aroused doubts about risk in emerging markets, the Latin American Governments (with only a few exceptions) decided to send out a clear signal that their priority was to be exchange-rate stability and, hence, austerity.

9. Another related factor was the widening of external disequilibria; this process had been under way for several years but worsened substantially for some countries as a result of the negative terms-of-trade shock of 1998. Markets were also less willing to finance these deficits, and the small amount of credit that was available became increasingly expensive, with no signs of a quick return to the falling rates and abundant credit that had characterized most of 1997.

10. Thus, there have been two turning points in recent macroeconomic policy. The first was the sharp change in course made in October 1997 when the Asian crisis began to have its first serious ramifications in Latin America and Governments began to adopt more cautious monetary and fiscal policies. The second turning point was marked by the intensification and reinforcement of this new line of economic policy as the international financial crisis deepened in August and September 1998.

Fiscal deficits widen

11. Despite more cautious policies, the average (unweighted) fiscal deficit for the region increased by one percentage point to 2.4 per cent of gross domestic product (GDP) in 1998. Although this is still quite low when compared to the figures for the 1980s, it is the highest to be recorded so far this decade. The main cause of this increase was a decline in current income due to slower growth. The fairly generalized reduction in tax revenues was accentuated by the slump in commodity prices, especially in the case of the petroleum-exporting countries (Ecuador, Mexico, Trinidad and Tobago, Venezuela) and metal exporters (Chile, Jamaica). At the same time, expenditure was trending upward owing to higher interest rates (Brazil), increased social budgets and higher public-sector wages, the extraordinary expenditures made necessary by natural disasters (El Niño in Peru and Ecuador, hurricanes in the Caribbean and Central America) and social security reforms (Bolivia, Uruguay).

12. In response to this situation, which had already become evident by the end of 1997, several countries (Argentina, Brazil, Colombia, El Salvador and Venezuela) raised taxes and bolstered their tax collection efforts. As part of a more widespread response, many Governments in the region also began to make adjustments on the expenditure side, chiefly through reductions in spending on infrastructure and other investment outlays. Public-sector employment and current government consumption were also cut in some cases, but the general tendency was to protect social-sector expenditure. Nevertheless, these efforts proved insufficient to hold down costs and compensate for lower revenue, and in most cases fiscal policy thus failed to play a useful role in cooling domestic demand or in controlling countries' rising external deficits.

Monetary policy tightened substantially

13. Under these circumstances, most of the burden of adjustment has fallen on monetary policy. The expansion of the money supply and credit facilitated economic growth during 1996 and most of 1997, accommodating the increased demand for local currencies generated by the reconstitution of real monetary balances once their purchasing power had been restored. In October 1997, there was an abrupt change in this trend. After reaching a peak of about 18 per cent in real terms, the average monetary growth rate began to slow and has been falling steadily ever since. It was almost zero in June and July 1998, and thereafter turned negative. In several countries, the drop in the real money supply reached two digits.

14. This trend in the real money supply during 1998 was attributable to the decrease in foreign assets experienced by most countries in the region. This was not offset by easier domestic credit terms since interest-rate policy has been used to attract foreign capital and protect the value of the currency when it has come under attack. The higher cost of credit has also been instrumental in reducing the expansion of domestic demand and keeping it in line with the slower pace of economic growth.

15. Real deposit rates, whose across-the-board average was slightly negative at the beginning of 1998 due to seasonal inflationary factors, started to climb in April. Decreasing rates of inflation compounded the rise in nominal interest rates in the second semester, and the region's average deposit rate at year's end stood at 10 per cent. In some countries, such as Brazil, real interest rates were much higher. Interest rate hikes for lending were consistently higher than the increases in rates on deposits, so spreads widened.

16. Overall, monetary policy was successful in cooling down the region's economies (the growth of domestic demand turned out to be negative for the fourth quarter of 1998 in many countries of the region) and preserving the value of their local currencies. As a consequence of a number of Governments' decision to rely entirely on monetary instruments in their quest for equilibrium, however, financial costs have reached new highs that may jeopardize future growth prospects. In countries with weak financial sectors, the surge in real interest rates, coupled with slower economic growth, translated into an increase in non-performing loans and a further deterioration of bank assets. Some countries were again hit by banking crises (Ecuador, Paraguay), while others faced greater than expected difficulties in sorting out the consequences of past ones (Jamaica, Mexico).

Exchange-rate policy increasingly controversial

17. With the tightening of international and domestic credit markets and the resulting slowdown in most economies of the region, the issue of exchange-rate policy became increasingly contentious. Subjects of debate included the exchange-rate regime itself, the use of the exchange rate in stabilization programmes and consistency in the management of semi-flexible systems.

18. Mounting external deficits drove up the net demand for hard currencies. In general, however, economic authorities did not allow the market to set parity rates for fear that the climate of widespread uncertainty in international markets might degenerate into uncontrollable devaluations. Financial stability and domestic solvency were also taken into account in defining the acceptable rate of devaluation, as previous episodes of sustained inflows of external capital and local currency appreciation have left many debtors heavily exposed to exchange-rate risk. Another objective in limiting nominal devaluations was to guard against setbacks in terms of inflation control.

19. In these instances, the monetary authorities drew on their reserves to forestall excessive devaluations and hiked interest rates to ward off capital flight. Even in Mexico, one of the few economies with a floating exchange-rate regime, the authorities intervened energetically when pressures began to mount at the start of the second semester. In some cases, especially in Brazil, this policy had two very serious consequences: extremely high interest rates and a loss of reserves. In order to avoid having to modify its exchange-rate regime, Brazil had to request an international rescue package coordinated by the International Monetary Fund. Even so, several countries have revised their exchange-rate policies to accommodate currency devaluations, either by altering the managed floatation band so that the pressure on their currencies can manifest itself in the flexible rate, or by increasing the rate of preannounced devaluations under crawling peg regimes.

20. The greater control gained over inflation in the region and the increased nominal devaluation rate put an end to the tendency towards appreciation which the average real exchange rate has exhibited for much of the 1990s. In the second semester of 1998, there were even some signs of a small depreciation in the region, although substantial differences across countries continued to be observed in terms of both exchange-rate movements and their underlying causes.

Reforms advance despite troubled economic situation

21. The problematic economic situation existing in 1998 did not seriously affect the structural reform programmes under way in the region. In fact, a record US$ 40 billion in assets were privatized during the year; Brazil led the way, since it accounted for 90 per cent of this figure, with much of that sum being represented by the sale of the national telephone company. A number of the region's smaller economies, including those of Central America, were also very active in this area. The privatization and concession process encompassed a wide range of sectors, including everything from telecommunications to public utilities and postal services. Other areas of reform were the labour market, the civil service and the pension system.

22. Trade reforms also moved ahead, with no loss of momentum being noted even in countries troubled by mounting external deficits. Chile, for example, decided to lower its external tariffs in an effort to reach an across-the-board rate of 6 per cent within the next five years, and the Central American countries, too, proceeded with their calendar for reducing their level of external protection.

23. The four trade groups in the region — the Southern Cone Common Market (MERCOSUR), the Andean

Community, the Caribbean Community and the Central American Common Market — continued to make headway with the implementation of their integration agreements. Special emphasis was placed on finding ways to promote convergence among these groups, with MERCOSUR and the Andean Community taking the lead. The progress made in this respect is still quite limited, however, and the devaluation of the Brazilian currency complicated the situation further at the beginning of 1999. As part of another initiative in this field, negotiations on a broader, hemisphere-wide agreement were begun with a view to the establishment of the Free Trade Area of the Americas by the year 2005.

III. Domestic economic performance

Regional growth slows

24. The strong expansion in the level of activity seen in the Latin American and Caribbean countries during 1997 — one of the highest growth rates in recent decades — slackened quite abruptly in 1998. The average GDP growth rate for 1998 is estimated at about 2.2 per cent, more than a full percentage point lower than the average for the 1990s. Per capita GDP should grow by about 0.5 per cent, putting it 15 per cent above its level at the beginning of the decade. Because of its size, the Brazilian economy's sluggish growth rate strongly influenced the regional average. Even if Brazil is factored out of the calculations, however, the slowdown still appears to be quite sharp, with the rate falling from 6.6 per cent in 1997 to 3.5 per cent in 1998.

25. This slowdown in the overall level of activity was due to the results recorded by 13 of the countries in the region (notably Argentina, Brazil, Guyana, Peru and Venezuela, where growth in 1998 was between 3.5 and 7 points lower than the year before, although Paraguay and Venezuela, in Latin America, and Guyana and Jamaica, in the Caribbean, are the only countries in which an actual contraction was recorded for the year as a whole. Costa Rica was the one country to buck this trend and turn in a substantially better performance than the year before, with a 6 per cent growth rate that was second only to the figure for the Dominican Republic, which posted a 7 per cent rate for the third year in a row. Quite high growth rates (between 4 and 6 per cent) were reported by eight countries and another seven had rates of between 2 and 4 per cent.

26. The downswing in the region's economies was more serious than the above figures suggest because in many countries it deepened as the year drew on. In the early months of 1998, their economies continued to exhibit the strong dynamism they had shown in 1997, but as the impact of the international financial crisis began to make itself felt through a steep drop in capital inflows, which in several countries compounded a severe deterioration in the terms of trade, the expansion of output began to flag, coming to a virtual standstill in the final months of the year. The downturn in the terms of trade also affected national income, which is estimated to have edged up by just slightly more than 1 per cent.

27. Investment was a stimulus for growth in most of the countries, since it outpaced GDP. Thus, when measured as a share of output for the region as a whole, this variable shows a slight increase over its 1997 level. Since public-sector investment funds were cut back in many instances as part of Governments' attempts to control their fiscal deficits, most of the growth in investment came from the private sector, with foreign direct investment flows playing a key role in this respect. Consumption expanded at much the same rate as total output, while export volumes progressed (8 per cent), but at a considerably slower pace than in the past. The volume of imports also grew more slowly than before (10 per cent vs. 26 per cent), but nonetheless continued to outdistance the rate for exports.

28. The unfavourable conditions observed in 1998 were reflected more clearly in the industrial activity of the countries of the region. The most serious downturn was in Brazil, where industrial output is expected to have dropped by 3 per cent after having climbed by over 4 per cent in 1997. The results were also poor in Argentina, where industrial activity slid during the closing months of 1998 following a strong performance early in the year. The same thing happened in Chile, Colombia and Venezuela, all of which exhibited clearly recessionary trends in the final quarter. Mexico's industrial growth rate also slumped towards the end of the year, but the rate for the first nine months of 1998 was much higher (nearly 8 per cent). Nevertheless, the downward trend was expected to deepen from the fourth quarter of 1998 on. The situation was quite different in Peru, where activity waned in the first two quarters as a consequence of El Niño, which had a particularly serious impact on the production activity of industries that process agricultural and fishery products. Activity then rebounded during the second half of the year once the adverse weather conditions caused by this phenomenon came to an end.

29. Economic activity in a number of countries was adversely affected in 1998 by El Niño, which caused serious droughts and flooding that had a particularly severe impact on agriculture. Housing, social infrastructure and production facilities were destroyed or damaged by extensive flooding

along the coasts of Peru and Ecuador and in various areas of Argentina, Chile, Brazil and Paraguay. Fisheries were also hurt by this phenomenon. In the closing months of 1998, Central America and the Caribbean were hit by two hurricanes that caused an enormous amount of destruction. Honduras and Nicaragua were hit particularly hard in late October by Hurricane Mitch, which also damaged Guatemala and El Salvador. Preliminary estimates put the direct and indirect losses at over US$ 7 billion.

Outlook for 1999 is problematic

30. The economic growth of Latin America is expected to weaken further in 1999 as a result of the continuing international economic crisis and the impact of the adjustment policies that countries have begun to implement in order to cope with it. The region's export prices will remain low for at least several more months, which will hurt its balance of payments and fiscal accounts. This will make it necessary to proceed with macroeconomic adjustment measures that will lead to a contraction of economic activity. In some of the Central American and Caribbean countries, these factors will be compounded by the effects of the storms and other adverse weather conditions that affected them during the second half of 1998. These phenomena seriously impaired vital economic activities, and the after-effects are expected to persist for quite some time.

31. The region's overall growth rate is expected to be slightly negative, with a rate of over 5 per cent being registered by only one country and actual decreases in the level of activity in four of the 19 economies considered. The crisis in Brazil will severely affect its main trading partners in MERCOSUR, particularly Argentina.

Inflation stabilizes at its low 1997 level

32. After the steep reduction in inflation seen between 1990 and 1997, the regional rate fell only marginally in 1998. In recent years, a dramatic drop had been observed, with inflation plummeting from 882 per cent in 1993 to 335 per cent in 1994, 26 per cent in 1995, 18 per cent in 1996 and 10.3 per cent in 1997. For 1998, the rate for the 12 months to December is estimated at 10.2 per cent, the lowest in nearly 50 years. The significance of the average rate is reinforced by the fact that 13 of the 22 countries considered had single-digit inflation rates. Moreover, in the majority of countries the rate fell or remained low; only Ecuador, Nicaragua and Paraguay had significant increases. Although Venezuela reduced its rate from 38 per cent to 30 per cent, this was still high in comparison with the region's current patterns and was exceeded only by Ecuador, where prices rose by 43 per cent.

33. Argentina continued to maintain its record as best performer, registering near zero inflation, as it had also done during the two previous years. Brazil consolidated its control over price increases as, after experiencing four-digit inflation in the late 1980s and early 1990s, its inflation rate in 1998 was only 2.5 per cent. The biggest advances occurred in the Dominican Republic, Haiti and Uruguay; in the case of Uruguay, the inflation rate may well turn out to have been the lowest since 1957. Currency devaluations were the primary cause of inflation in a number of countries (Ecuador, Nicaragua and Paraguay).

34. The significant deceleration of inflation in the 1990s has mainly been due to a change in economic policy in recent years. The fight against inflation has come to be the highest priority of macroeconomic policy, and this policy effort worked in conjunction with structural reforms and a promising international environment until mid-1997. The financial problems affecting the world economy in 1998 did not have strong repercussions on domestic prices. With the exceptions mentioned above, devaluations did not translate into significant price rises either, given the restrictive monetary policies and recessionary situation that existed in various countries of the region.

Labour markets suffer a reverse

35. The slower rate of economic growth in 1998 translated into higher unemployment, which rose from 7.3 per cent on average for the region in 1997 to 7.9 per cent in 1998. This increase was primarily due to a worsening situation in the labour market in Brazil and Colombia, where unemployment climbed significantly. In contrast, thanks to a relatively rapid pace of growth — even if slower than the year before — the annual average rate of unemployment in most of the countries in the region was stationary or even fell. Sizeable reductions in joblessness were reported in Argentina, Barbados, the Dominican Republic, Mexico, Nicaragua, Trinidad and Tobago, and Uruguay. It is important to note, however, that all of these countries except Mexico still have double-digit unemployment rates.

36. In the second half of the year, the deceleration of growth in many countries began to be reflected in the labour market. Accordingly, the unweighted average rate of employment for the countries having this information available — which had risen sharply in the second half of 1997 and moderately in the first half of 1998 — showed a small decline. The weighted average employment rate exhibited a different trend, with a large decrease in the first

part of the year and a small upswing in the second; this was mainly due to the influence of Brazil, where this latter pattern predominated.

37. Overall, the employment rate was down. Specifically, the demand for labour weakened in various formal sectors of activity that were hurt by the problems existing in the external sector and by adjustment measures; this is what occurred, for example, in Chile's mining, forestry, fishery and construction industries. In some of the countries ravaged by natural disasters, jobs were lost in agriculture, as in the case of Honduras' banana plantations. Most countries saw a reduction in employment in manufacturing as a consequence of the more sluggish growth of domestic demand, external competition and labour-saving restructuring plans. As a result, in many cases job creation was concentrated in informal sectors of the economy in 1998. In some countries, however, such as Mexico, the buoyancy of the economy also led to the creation of a significant number of jobs in formal sectors of activity.

38. In the context of a slacker demand for labour, real wages in the formal sector stagnated or fell slightly in most countries. In fact, of the countries having information available, only Chile and Uruguay registered increases of more than 1 per cent.

IV. External sector

Current account deficit continues to widen

39. The combined effects of an international financial crisis and a series of weather disasters were reflected in the deteriorating position of the external sector in the majority of the countries. Thus, the trend towards widening current account deficits intensified. The aggregate regional deficit rose from 2 per cent of GDP in 1996 to over 3 per cent in 1997 and topped 4 per cent in 1998, although the latter percentage was pushed up by the devaluation of many of the countries' currencies, which lowered the value of GDP measured in dollars. The current account deficits were close to the regional average in the three largest economies (Argentina, Brazil and Mexico) but reached levels around or above 7 per cent of GDP in Chile and the Andean countries other than Venezuela.

40. The increased current account deficit for Latin America and the Caribbean in 1998 was due to the marked deterioration in the trade balance since factor services did not change much. Although profit remittances continued to expand, interest payments increased very little. In contrast to 1997, in 1998 the region had to resort to international reserves and compensatory capital in totalling nearly US$ 21 billion to finance the current account deficit. The decline in reserves was particularly marked in Brazil, Chile and Venezuela, and somewhat less so in Colombia and Peru. On the other hand, some countries did increase reserves, notably Argentina and Mexico.

41. Although the trend towards deteriorating current accounts and trade balances continued, the reasons for it were radically different from what they had been in previous years. Whereas in recent years the import-export gap was due to a surge in imports, in 1998 it was due chiefly to a weakening trend in the value of exports.

Exports slacken

42. The value of regional merchandise exports declined, albeit marginally, for the first time in 12 years. This change, as compared to the previous year, was due to a sharp drop in prices, which was not totally offset by the slower growth in export volumes.

43. The unit value of the region's exports declined on average by more than 8 per cent. This reflected the sharp drop in commodity prices in world markets, which were heavily influenced by the financial crisis that erupted in Asia during the second half of 1997. Prices of raw materials, both from mining and agriculture, were particularly affected. The average price index elaborated by ECLAC shows a decline with respect to the previous year of 15 per cent in the prices of minerals and tropical beverages and more than 10 per cent in the prices of food and agricultural raw materials. Moreover, during the first quarter of 1999, the prices of many products continued to drop.

44. The price of oil was halved between October 1997 and December 1998, falling to its lowest level in 12 years. That one fact explains why Venezuela experienced by far the greatest decline (25 per cent) in export unit value. Ecuador, Chile and Peru suffered declines of between 13 and 14 per cent. The latter two countries were hard hit by the falling prices of metals, particularly copper. In Colombia and Paraguay, the losses were about 10 per cent, while some other countries experienced smaller but still substantial declines. In the Central American countries, export unit values either declined slightly or held stable; banana prices were firm, and there was a lag before the drop in the price of coffee was reflected in sale contracts. The Caribbean countries were variously affected: Trinidad and Tobago suffered losses in terms of its exports of hydrocarbons and petrochemical products that amounted to the equivalent of 2 per cent of GDP, while Guyana and Jamaica were hurt by lower prices for bauxite.

45. The majority of the countries were able to make up for the drop in prices to some extent by expanding export volumes, but growth in that respect was less dynamic than in previous years because of the problems importing countries were experiencing. Reduced demand was most evident in the Asian economies, and this seriously dampened export sales for Chile and Peru in particular. Also a factor was the economic slowdown in some other countries, such as Brazil, an important market for many Latin American exporters. The good performance of the United States economy, by contrast, benefited Mexico in particular as a member of the North American Free Trade Agreement (NAFTA).

46. On the other hand, preliminary figures suggest that exports of manufactures were the best performers in some countries of the region, and helped to soften the impact of the declines in primary commodities, which make up the bulk of the region's exports. These differing trends are consistent with indications that exports to other markets within the region again grew more rapidly than exports to the rest of the world. The data so far available suggest a clear tendency in that direction within the Andean Community and the Central American Common Market, but the trend was halted in the case of MERCOSUR by the impact of the cooling of the Brazilian economy on the exports of its neighbours.

Imports slow and terms of trade worsen

47. Imports slowed throughout the region as domestic demand weakened and the currencies of many of the countries, for the first time in several years, underwent real depreciation. The most drastic adjustment occurred in Brazil, nearly the only country where import volume actually contracted. There, as in the other large economies, the flow of imports remained heavy during the early months of the year but gradually slackened as the domestic economic situation deteriorated. Growth in import volume for the region as a whole was 11 per cent, considerably less than half the figure for the year before, but similar to that for 1996.

48. In value terms, the reduction was even greater, as prices of imported products fell significantly throughout the region. One factor was the worldwide decline in prices of manufactures, reflecting lower prices for raw materials and more intense competition due to the devaluation of Asian currencies; at the same time, petroleum and other raw materials imported by the countries of the region became cheaper. As a result, the region's bill for imports of goods increased by only about 5 per cent, after two years of strong expansion. Currency savings were especially significant in purchases of oil and gas; most of the petroleum-importing countries for which information is available paid from 20 to 40 per cent less than the previous year for oil and gas.

49. The slackening pace of imports was due in part to greater difficulty in financing them, owing to constraints on external borrowing and slower growth of the purchasing power of exports. The latter expanded by only a little over 3 per cent for the region as a whole, owing to a combination of weak growth in export volumes and the deterioration in the terms of trade.

50. The decline in the region's terms of trade, however, was limited to 4 per cent, thanks to the considerably cheaper prices for imports. While roughly half the countries suffered a deterioration in their terms of trade, the other half found that lower prices for their exports were more than offset by lower prices for the products they imported. The chief gainers in this respect were the Central American countries, Uruguay and the Dominican Republic, where the effect of the improvement in the terms of trade was equivalent to about 1 per cent of GDP or more; in the case of Honduras the figure was 3 per cent, in Nicaragua 4 per cent. The chief losers were the exporters of petroleum (Ecuador, Trinidad and Tobago, and above all Venezuela) and metals (Chile, Jamaica, Guyana). Terms-of-trade losses exceeded 5 per cent of GDP in Venezuela and 2 per cent in Chile and Ecuador. In Brazil, the two effects offset one another.

51. The net aggregate effect of the variation in the terms of trade for the region as a whole was negative and amounted to over US$ 10 billion, equal to nearly half of the international reserves lost by the region in 1998 and to 0.5 per cent of the region's GDP for the year.

Capital inflows moderate

52. The impact of the international financial crisis on capital flows to Latin America, already observable in some countries of the region in the fourth quarter of 1997, was felt more broadly in 1998, especially from August onward, as the region began to experience the effects of the devaluation of the rouble and the Russian Federation's unilateral debt moratorium. In 1998, Latin America received only US$ 62 billion in capital inflows, compared with an influx of US$ 80 billion in 1997 (as a percentage of GDP, a decline from 4.2 to 3.2 per cent). Autonomous capital inflows declined in over half of the Latin American and Caribbean countries. Among those most heavily affected were Brazil, Chile and Peru; Venezuela continued to record a net outflow. Five others, notably Argentina, managed to increase their external financing.

53. A significant feature of external financing in 1998 was that a large proportion continued to take the form of medium-term and long-term funds, especially foreign direct investment. In several countries, lending from multilateral organizations assumed greater importance, including some important loan commitments for disbursement in 1999. On the other hand, there were outflows of short-term capital and sharp declines in stock market investment in most of the countries of the region. The latter occurred chiefly between August and October 1998, when substantial short-term capital flight occurred, especially from Brazil.

54. Net foreign direct investment inflows to the region remained close to the extraordinary level of US$ 57 billion achieved in 1997. In nine Latin American countries, foreign direct investment again financed over half of the current account deficit on the balance of payments. The chief beneficiary was Brazil, which received a record US$ 22.5 billion. Much of that amount came from the privatization of the telecommunications system, the largest such sale in the history of Latin America. Although flows to Argentina, Chile, Colombia and Mexico slowed, they nonetheless contributed significantly to financing the current account deficit. Also important were the direct investment flows to some Central American and Caribbean countries, notably El Salvador and Guatemala.

55. Bond issues in the first half of 1998 amounted to US$ 28 billion in gross terms, a figure similar to that recorded in the first half of 1997. Argentina, Brazil, Mexico and Venezuela continued to account for most issues. The cost of external financing did not increase significantly during the first half of the year. Towards the end of August, however, the cost of financing in the secondary market rose considerably, to nearly 15 per cent per annum, and then only partially reversed course during the closing months of the year. Because of the higher cost, Governments and companies in the region placed no new bond issues between August and October 1998. It was not until November that the Government of Argentina tested the waters with a bond issue for US$ 1 billion, the first major issue to come out of the region since the international crisis intensified in August; it was followed by an issue for US$ 1.5 million by Pemex of Mexico. As a result of this adverse effect during the second semester, the total value of issues during the year (US$ 38 billion) was 30 per cent lower than in 1997. This trend continued during the first quarter of 1999, with the notable exception of Mexico.

56. Bank credit to the region rose by only 5 per cent in the first half of 1998, and loans were concentrated entirely in the first quarter. Since the eruption of the Asian crisis in October 1997, at times syndicated loans have been the only external credit option open to some Latin American countries. Moreover, they have offered better credit terms than bonds. However, syndicated financing has been very selective, available only to a few Governments and companies in the region. Supplier credit, on the other hand, which makes up the greater portion of short-term debt in most of the economies, has continued to be granted as usual.

57. The international financial crisis depressed stock market prices; between October 1997 and mid-September 1998, the region's stock exchanges all registered declines. During that period, the regional index fell by a cumulative 50 per cent after several years of gains. Although in mid-September the regional index of stock prices began to recover, by December 1998 it still had not risen above the level reached at the beginning of 1996. Thus, foreign investment in stock market assets was one of the flow components most heavily affected during 1998. By September 1998, it had dropped off by US$ 10 billion in the countries of the region for which information is available. One of the elements of stock market investment, issues of American Depositary Receipts, which had reached US$ 5 billion in 1997, was negligible in 1998 (US$164 million).

The pace of growth of the external debt quickens

58. In 1998, the region's external debt expanded to some US$ 700 billion, increasing by 7 per cent in nominal terms, a pace faster than the previous year's and similar to the growth rate in 1995. The expansion was not evenly distributed, however, and was attributable largely to the increased external debt of a few countries, chiefly Argentina, Brazil and Chile. In Chile, the increase was due to greater private-sector borrowing, whereas in Argentina the expansion of the public sector's external debt was the key factor. Other countries did not increase their external debt significantly, and some may have actually reduced it in nominal terms.

59. For the first time in the 1990s, the indicators of the region's external debt burden reflected a change for the worse, chiefly because of the stagnation in exports of goods and services. For example, the ratio of accrued interest to exports of goods and services rose from 14.3 to 15.2 per cent, and the ratio of the external debt to exports of goods and services rose from 194 to 209 per cent. Although the deterioration was widespread, debt indicators for half of the countries were still considered acceptable. For the other countries, especially some of the Central American countries, indicators continued to provide grounds for concern.

60. With regard to external debt renegotiation, in 1998 a debt relief programme went into effect in Bolivia under the terms of the Heavily Indebted Poor Countries Debt Initiative. Also under that initiative, the International Monetary Fund, the Inter-American Development Bank and the World Bank announced that they were considering the possibility of an external debt relief programme for Nicaragua and Honduras.

Latin America and the Caribbean: total gross domestic product

(Percentages based on values at 1995 prices)

	Annual growth rates								*Average annual rate*			
	1991	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998[a]*	*1981*	*1990[b]*	*1991*	*1998*
Latin America and the Caribbean[c]	**3.8**	**3.2**	**3.8**	**5.8**	**1.0**	**3.6**	**5.5**	**2.2**		**1.0**		**3.6**
Latin America and the Caribbean (excluding Brazil)	**5.7**	**5.4**	**3.4**	**5.5**	**-1.0**	**4.1**	**6.6**	**3.5**		...		**4.1**
Subtotal (19 countries)[c]	**3.8**	**3.2**	**3.9**	**5.8**	**1.0**	**3.6**	**5.5**	**2.2**		**1.0**		**3.6**
Subtotal (19 countries excluding Brazil)	**5.8**	**5.5**	**3.5**	**5.5**	**-1.1**	**4.1**	**6.6**	**3.5**		...		**4.2**
Argentina	10.0	8.9	5.8	8.3	-3.1	4.4	8.0	4.2		-0.7		5.7
Bolivia	5.4	1.7	4.2	4.8	4.7	4.4	4.2	4.7		0.2		4.3
Brazil	1.0	-0.3	4.5	6.2	4.2	2.9	3.8	0.2		1.3		2.8
Chile	7.3	11.0	6.6	5.1	9.1	6.8	6.4	3.3		3.0		6.9
Colombia	1.6	3.9	4.5	6.3	5.4	2.0	3.2	0.2		3.7		3.4
Costa Rica	2.2	7.1	5.8	4.3	2.2	-0.5	3.4	6.2		2.2		3.8
Cuba[d]	–	–	–	0.6	2.4	7.8	2.5	1.5		3.7		-3.1
Ecuador	5.0	3.0	2.2	4.4	3.0	2.3	3.9	0.8		1.7		3.1
El Salvador	2.8	7.3	6.4	6.0	6.2	1.9	4.0	3.4		-0.4		4.7
Guatemala	3.7	4.9	4.0	4.1	5.0	3.0	4.3	4.7		0.9		4.2
Haiti	0.1	–	-2.2	-8.3	5.0	2.8	1.3	2.9		-0.5		-1.7
Honduras	2.7	5.8	7.1	-1.9	3.7	3.8	5.1	3.0		2.4		3.6
Mexico	4.2	3.7	1.7	4.6	-6.2	5.5	7.1	4.8		1.8		3.1
Nicaragua	-0.3	0.8	-0.4	4.0	4.5	4.8	5.5	4.0		-1.5		2.8
Panama	9.0	8.2	5.3	3.1	1.9	2.7	4.9	3.9		1.4		4.8
Paraguay	2.5	1.7	4.0	3.0	4.5	1.1	2.4	-1.0		3.0		2.3
Peru	2.9	-0.6	6.0	14.7	8.8	2.2	8.2	0.7		-1.2		5.3
Dominican Republic	0.8	6.4	2.0	4.3	4.5	6.8	7.1	7.3		2.4		4.9
Uruguay	2.9	7.4	3.1	5.5	-2.0	5.0	5.0	4.0		0.0		3.8
Venezuela	10.6	7.1	-0.5	-3.8	5.5	-0.9	5.5	-0.7		-0.7		2.7
Subtotal Caribbean[c]	**1.7**	**1.0**	**0.4**	**3.4**	**2.4**	**3.0**	**1.9**	**1.2**		**0.1**		**1.7**
Antigua and Barbuda	4.1	1.0	3.5	4.8	-4.3	5.5	4.6	...		6.1		2.7[e]
Barbados	-3.5	-5.4	1.0	3.6	2.5	5.1	3.0	2.0		1.1		1.0
Belize	3.2	8.9	4.0	1.6	3.5	1.1	4.4	1.4		4.5		3.5
Dominica	2.6	3.0	2.2	2.1	2.3	2.9	2.4	2.4		4.4		2.5
Grenada	3.7	1.0	-1.1	3.4	3.0	3.2	4.7	5.9		4.9		3.0
Guyana	10.2	11.2	3.1	17.7	2.4	9.2	6.1	-1.6		-2.9		7.1
Jamaica	0.3	2.5	1.8	1.9	1.7	-0.5	-2.3	-3.5		2.2		0.2
Saint Kitts and Nevis	3.4	3.6	6.7	3.3	3.1	5.5	...	...		5.8		4.3[e]

	Annual growth rates								Average annual rate			
	1991	1992	1993	1994	1995	1996	1997	1998[a]	1981	1990[b]	1991	1998
Saint Vincent and the Grenadines	0.1	8.9	-0.3	-3.3	8.3	1.4	2.2	..		6.5		2.4[c]
Saint Lucia	-2.0	7.3	0.4	1.9	0.7	0.5	0.9	1.9		6.8		1.4
Suriname	3.5	-1.7	–	-2.3	-4.7	8.7	5.0	...		0.5		-0.4[c]
Trinidad and Tobago	3.5	-1.1	-1.2	4.2	4.1	4.5	4.0	5.0		-2.6		2.8

Source Economic Commission for Latin America and the Caribbean, on the basis of official figures converted into dollars at constant 1995 prices.

Note Totals and subtotals do not include those countries for which no information is given.

[a] Preliminary estimates.

[b] Calculated on the basis of figures at constant 1990 prices.

[c] Excluding Cuba.

[d] Calculated on the basis of constant prices in local currency.

[e] Based on figures at factor cost.

[f] 1991–1997.

[g] 1991–1996.

United Nations

E/1999/19

Economic and Social Council

Distr.: General
15 April 1999

Original: English

Substantive session of 1999
Geneva, 5–30 July 1999
Item 10 of the provisional agenda
Regional cooperation

Summary of the survey of economic and social developments in the Economic and Social Commission for Western Asia region, 1998–1999

Executive summary

Economic and Social Commission for Western Asia (ESCWA) members'* overall economic performance was dismal in 1998. Preliminary estimates indicate that the combined real gross domestic product (GDP) of the region, excluding Iraq due to lack of reliable data, increased only by 1.0 per cent on average. This represents a significant decline from the annual growth rates of 3.7 per cent in 1996 and 3.4 per cent in 1997. With the region's high population growth rate of 2.5 per cent, real GDP per capita in the region registered a negative 1.5 per cent growth. The 1998 combined real GDP of the Gulf Cooperation Council (GCC) countries** as a group contracted by 0.02 per cent compared to its 1997 level, while the combined real GDP among the more diversified economies*** registered a positive 3.6 per cent annual growth rate in 1998. Thus, the more diversified economies were not as adversely affected by a 34 per cent decline in oil prices and a 29 per cent decline in oil revenues as were the GCC countries. Nevertheless, repercussion of the dismal economic performance among the GCC countries was felt in some of the more diversified countries.

For a number of reasons — including the currently high levels of oil inventories, expected increases in production in Iraq and Central Asia, and depressed oil demand in the economies of East and South-East Asia — no major lasting improvement in oil prices is expected in 1999. Thus, the ESCWA region's oil revenues are expected to increase only moderately in 1999.

* Including Bahrain, Egypt, Iraq, Jordan, Kuwait, Lebanon, Oman, Palestine, Qatar, Saudi Arabia, Syrian Arab Republic, United Arab Emirates, Yemen.

** Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates.

*** Including Egypt, Iraq, Jordan, Lebanon, Syrian Arab Republic, Yemen, West Bank and Gaza Strip.

99-10824 (E) 180599

Unemployment, a chronic problem facing the region's more diversified economies, worsened in 1998, mainly because the economic growth in the member countries was not sufficient to generate employment opportunities adequate to absorb the rapidly increasing labour supply. In addition, the economic slowdowns or contractions in the traditionally labour-receiving GCC countries reduced the demand for expatriate workers, therefore exacerbating the problem. The GCC countries themselves are now facing unemployment problems caused by a rapidly increasing indigenous labour force. These countries are now considering adopting appropriate policies to secure employment opportunities for their nationals. The problem of unemployment in the ESCWA region is expected to get worse in 1999.

Inflation rates in the ESCWA region had been declining in recent years, and are estimated to have fallen further across the board in 1998. The currencies of all the GCC countries are pegged to the United States dollar. One exception is the Kuwaiti dinar, which is pegged to a basket of currencies, although 70 per cent of the basket is accounted for by the dollar. The GCC currencies appreciated along with the dollar against Japanese yen, most other Asian and Western European currencies. Currencies of more diversified economies, excluding Iraq and the Syrian Arab Republic, have also generally remained stable against the United States dollar. Therefore, the prices of imported goods to ESCWA member countries from most of their trading partners declined significantly, pushing down inflation rates.

Due to the steep decline in oil prices and export revenues, the total value in 1998 of the ESCWA region's exports, excluding the West Bank and Gaza Strip, is estimated at US$ 97.1 billion, a drop of 21.7 per cent from the 1997 level. The values of the region's total import are also estimated to have declined below the 1997 level as a result of the fall in oil revenues — the major source of financing imports — and a significant decline in commodity prices in the world markets. While the trade balance in the ESCWA region as a whole achieved a surplus of US$ 14.5 billion in 1997, it is estimated to have recorded a deficit of US$ 9.4 billion in 1998 and is projected to remain in deficit in 1999.

As of May 1998, the international reserves, minus gold, in the ESCWA region, excluding Iraq and the Syrian Arab Republic due to lack of data, increased by 1.3 per cent compared to the 1997 level to reach US$ 53.7 billion. The GCC countries' international reserves, accounting for 45.2 per cent of the ESCWA region's total reserves, increased by 3.2 per cent in 1998 from 1997, while the reserves of the countries with more diversified economies in 1998 amounted to US$ 29.4 billion in 1998, a contraction of 0.2 per cent.

The fiscal positions of ESCWA member countries deteriorated in general in 1998, and their budget deficits as percentages of GDP increased considerably compared to the preceding two years. Only Lebanon managed to decrease its budget deficit, from 23.5 per cent of GDP in 1997 to 15.0 per cent in 1998. Egypt maintained its budget deficit relative to GDP at basically the same level previously achieved — 1per cent. As a result, the GCC countries introduced important budgetary restraints in the fiscal year 1999, with a reduction in the pace of growth of capital expenditures. The countries with more diversified economies, faced with declines in the level of foreign aid and the spillovers from the GCC countries, also pursued tight fiscal policies in 1998, restricting the growth of both current and capital expenditures.

While most ESCWA member countries are blessed with large oil and natural gas reserves, the region lacks two other critical natural resources — productive land and accessible renewable water resources. The region's accelerated economic growth and

development as well as urbanization during the past decades have evidently been posing significant pressures on its limited natural resources and putting stress on the environment. In the absence of integrated national conservation strategies, soil and water abuses have led to soil degradation, loss of fresh non-renewable water reserves and deterioration in water quality.

The population of ESCWA member countries grew from 87.8 million in 1978 to 157.6 million in 1998, indicating an average annual increase of 2.9 per cent. The population in the region as a whole will reach 166 million by 2000 and 210 million by 2010, accounting for 5.0 per cent of the population in Asia. Urban population has been growing faster than either total or rural population in the region as a whole. While about 47 per cent of the region's total population lived in urban areas in 1975, that figure increased to 53 per cent in 1985 and 57 per cent in 1995, and is expected to reach about 60 per cent by 2000. The ESCWA region's population is young, with a large proportion under the age of 15: in 1998, about 41 per cent of the population were below 15 years of age, while only 4.0 per cent were older than 65. Large cohorts of new entrants to the labour force suggest the need of quality education to prepare them with adequate technical skills.

In spite of considerable progress made in the status of Arab women in the ESCWA region over the past decades, the gender gap in socio-economic status persists in most countries of the region. The continued inadequate participation in education by girls and adult women has seriously negative implications for their skill development and thus their employment opportunities, exacerbating the difficulties in accessing economic activities that can enhance income and revenue.

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I. Aggregate economic performance

1. The overall economic growth in the ESCWA region was dismal in 1998. Preliminary estimates indicate that real GDP of ESCWA member countries, excluding Iraq due to lack of reliable data, increased only by 1.01 per cent on average. This figure represents a significant decline from annual growth rates achieved in previous years: 3.69 per cent in 1996 and 3.37 per cent in 1997. In particular, given the region's high population growth rate of 2.5 per cent, real GDP per capita in 1998 registered a negative 1.49 per cent growth.

2. Real GDP growth rates varied significantly between the GCC countries and the remaining ESCWA member countries with more diversified economies, and among the countries within each group. The 1998 combined real GDP of the GCC countries as a group grew by only 0.02 per cent from 1997. Saudi Arabia and the United Arab Emirates are estimated to have registered negative real GDP growth rates — 0.6 per cent and 1.0 per cent, respectively. The major reason for such low annual growth rates was a sharp decline in oil prices and government revenues. Prices of Saudi Arabian petrochemical products in 1998 are estimated to have been lower than the prices in the previous year by more than 40 per cent. Saudi Arabia's economy was further adversely affected by the reduction in its government expenditures. The United Arab Emirate's real GDP is officially estimated to have contracted, suffering not only from a sharp drop in oil export revenues but also from a decline in its re-export trade, which was hampered by economic slowdowns in its neighbouring trading partners. Kuwaiti economy's growth was also adversely affected because of large reductions in planned government expenditures and structural economic imbalances. However, according to preliminary official estimates, it registered a positive 1.0 per cent annual growth. The 1998 economic performance of the other three GCC countries was also below that in 1997, while the economies of Bahrain, Oman and Qatar all are estimated to have grown positively. The Bahraini economy is the most diversified economy among the GCC countries, and thus benefited from the positive contributions by its non-oil sectors at a time of sharply falling oil revenues. Its GDP growth rate is expected to have registered 2.2 per cent. Oman benefited from the fruits of its economic reform policies introduced by the Government several years ago. Despite the adverse impact of sharp decline in oil prices, Oman's GDP is estimated to have grown by 2.5 per cent in 1998. The Qatar economy is estimated to have achieved a real GDP growth rate of 4.4 per cent, the highest among the GCC countries but considerably lower than the 15.5 per cent it achieved in 1997. A major contributing factor to this growth has been the 10.5 per cent increase in oil production, coupled with a rapidly rising return from the investment in its liquefied natural gas project.

3. The combined real GDP among the countries with more diversified economies registered a positive 3.58 per cent annual growth rate in 1998. In contrast to the GCC countries, this group was not as adversely affected by the decline in oil prices since late 1997. Nevertheless, repercussion of the dismal economic performance by the GCC countries was felt among some of the more diversified countries. As was the case with the GCC countries, each country experienced a lower growth rate than in 1997. Egypt, the largest economy in this group, is estimated to have grown at 4.7 per cent. This was slightly lower than the 1997 growth rate but nonetheless the largest among the countries with more diversified economies and also in the entire ESCWA region. Despite the lower oil revenues, greater competition to its non-oil exports and lower tourism revenues, the Egyptian economy performed remarkably well in 1998 as a result of the economic reform programme it had been implementing since 1991 under the auspices of the International Monetary Fund and the World Bank. The Lebanese economy is estimated to have grown at an annual rate of 3.8 per cent in 1998, close to the rates registered in the previous two years. This was the second highest economic growth rate in this group. The country's real GDP benefited from the expansion in its construction sector, which helped to reverse the slowdown that had begun in early 1996, and from the rising profits in its banking sector, which continued to benefit from the rather high interest rates. After registering high growth rates of over 5 per cent in 1996 and 1997, the economy in Yemen is preliminary estimated to have slowed down to 2.0 per cent in 1998. Given the country's relatively high population growth rate of 3.7 per cent, its real GDP per capita contracted by 1.7 per cent. Among the factors that contributed to the decline have been the sharp fall in oil prices and its export revenues, the curtailment in the Government expenditures as an attempt to prevent budget deficits from widening, poor performance of its industrial sector, and a considerable rise in interests rates on the Yemeni rial due to the monetary authority's attempt to maintain the exchange rate stability between Yemeni rial and the United States dollar. Jordan's real GDP, after registering an annual growth at 2.2 per cent in 1997, is estimated to have registered an even smaller rate of 1.7 per cent in 1998. As the country's population is growing at a high rate of 3.3 per cent, its real GDP per capita continued to contract, at a rate of 1.6 per cent in 1998. The

deterioration in the economic performance in the GCC countries and the financial crisis in the South and East Asian countries negatively affected Jordan. Its exports to these markets significantly declined. The Syrian Arab Republic is estimated to have experienced the smallest economic growth among the more diversified economies in 1998. A number of factors have contributed to this low 1.5 per cent real GDP growth rate, including sharp declines in oil prices and revenues since late 1997, falling prices of cotton exports, cutbacks in aid from GCC countries, and as a result a shrinkage in public investment projects. As for Iraq, its poor economic conditions remained unchanged in 1998 in the presence of the continued economic sanctions imposed since 1990. Despite the food-for-oil deal agreed by the Security Council in February 1998 that raised the ceiling of Iraqi oil sales to more than double the original level to US$ 5.26 billion for six months, the country's oil production capability had declined so drastically that it was not able to produce at the allowed maximum, in particular at the time of low oil prices. In the West Bank and Gaza Strip, real GDP growth is preliminarily estimated to have registered a positive 2.1 per cent in 1998, indicating faster economic growth than in 1997, when the annual growth rate was one per cent. A reduction in the number of days in which the borders were closed by Israeli authorities may have contributed to this improvement. However, given the population growth rate of 3.1 per cent, the real GDP per capita declined by 1.0 per cent.

4. Ten of the 13 ESCWA members are oil exporters. Changes in oil prices and revenues greatly impact government revenues, expenditures, budget deficits, economic growth, employment opportunities, intraregional aid and trade, and expatriate workers' remittance. The annual average OPEC crude-oil basket price in 1998 is estimated to have been US$ 12.3 per barrel, representing a 34 per cent decline from the 1997 annual average. This was the lowest annual average during the past 21 years. Moreover, in real terms, i.e., when inflation is accounted for, it was equivalent to the level prevailing before the first major increase in oil prices in 1974. As for oil production, the total output in the ESCWA region increased by one million barrels per day in 1998 to 18.3 million barrels per day, compared to the 1997 level. However, this 8 per cent increase in output did not sufficiently counterbalance the 34 per cent decline in prices. Preliminary estimates indicate that oil revenues in the ESCWA region as a whole totalled US$ 67.7 billion in 1998, declining by 28.6 per cent from the 1997 level of US$ 94.8 billion. This was only 37.7 per cent of the peak oil revenues achieved in 1980, US$ 179.7 billion, resulting in considerable negative effects on economic growth and development in the entire ESCWA region.

5. Oil prices continued to decline in the last quarter of 1998, reaching a monthly average of US$ 9.69 per barrel in December. For a number of reasons — including the currently high levels of oil inventories, expected increases in production in Iraq and Central Asia, and depressed oil demand in the economies of East and South-East Asia, particularly Japan — no major lasting improvement is expected in 1999. In spite of the possibility that OPEC prices may remain below US$ 10 per barrel on average in 1999, however, prices are projected to average above their 1998 level, although not significantly exceeding US$ 14 per barrel. For the OPEC basket price to increase to an annual average of US$ 14 per barrel in 1999, production by major OPEC members, including those which are also ESCWA members, must be reduced to below their 1998 levels, negating some of the increases in oil revenues owing to higher prices. As a result, the ESCWA region's oil revenues are expected to increase only moderately in 1999. Meanwhile, gas revenues are more likely to increase substantially in several ESCWA member countries, particularly in Oman and Qatar.

6. In addition to the development in the oil sector, which is the crucial factor affecting real GDP growth of the ESCWA region as a whole, the region's economic outlook will also depend on several other factors: speed and success of the implementation of economic reforms, progress in the Middle East peace process, and development pertaining to United Nations economic sanctions on Iraq. The ESCWA region's real GDP is expected to grow by 2.41 per cent in 1999. While this is an improvement upon the 1998 performance, it remains below the region's average annual population growth rate of 2.5 per cent. Thus, real GDP per capital will contract slightly. While two groups within the ESCWA region, the GCC countries and the countries of more diversified economies, will both grow at rates above 1998 levels, real GDP is expected to grow faster among the latter group (4.32 per cent) than among the former (1.64 per cent). However, on an individual country basis, the highest real GDP growth rate is expected in Qatar, achieving 6.0 per cent. The country will benefit not only from a small rebound in the oil sector but also from the considerable increases in its natural gas production. Oman is expected to grow at 3.0 per cent, the second highest growth rate among the GCC countries, owing to the benefit from its economic reform policies, encouragement of foreign investment and rising returns from liquefied gas projects. The economies of Saudi Arabia and the United Arab Emirates are also expected to rebound, and their real GDP growth is projected to

register positive 1.5 per cent and 1.3 per cent, respectively. Real GDP of Bahrain and Kuwait will also grow in 1999, albeit at smaller percentages. As for the countries with more diversified economies, their economies are all expected to grow in 1999 faster than in 1998. The real GDP of Egypt is projected to accelerate by 5.1 per cent, the highest among this group and the second highest among all ESCWA members. Enhanced performance of privatized companies and an increase in its non-oil exports through bilateral trade agreements will lead the country's rapid economic growth. Lebanon's real GDP is expected to grow by 4.5 per cent in 1999. It is expected that combination of declining interest rates and a moderate depreciation of Lebanese currency, as well as a significant increase in the number of tourist arrivals, will boost the Lebanese economy. The economies of Yemen and the Syrian Arab Republic will benefit from higher oil revenues and enhanced performance by the private sectors. The West Bank and Gaza Strip is also expected to witness improvement in its economic growth, owing in part to expected financial and technical supports from donor communities.

7. Unemployment had been a chronic problem confronting the region's more diversified economies. The situation worsened in 1998 as the economic performance failed to generate employment opportunities sufficient to absorb the rapidly increasing labour supply. In addition, the economic slowdowns or contractions in the traditionally labour-receiving GCC countries resulted in shrinking the demand for expatriate workers, which further exacerbated the problem. Yemen and Jordan are estimated to have recorded the highest unemployment rates in 1998 in the ESCWA region, with preliminary estimates of 27 per cent and 21 per cent, respectively. Both fiscal and monetary policies of Yemen were highly contractionary: a sharp drop in the oil revenues forced the Yemeni Government to curtail its expenditures, and interest rates were raised significantly for the purpose of stabilizing the local currency against the United States dollar. These factors collectively constrained domestic economic growth, thus raising the level of unemployment. Jordan also pursued restrictive monetary and fiscal policies, and suffered from the decline in the employment opportunities in the GCC countries. With its high labour growth rate of approximately 5 per cent, coupled with a large number of foreign workers in the country, the Jordanian Government began implementing a policy of cracking down on about 300,000 foreign workers who did not have valid working permits. The Egyptian Government estimated its unemployment rate in 1998 to be slightly below 10 per cent, while other sources, including the International Labour Organization, estimate it at 17 per cent. The economy of Egypt would be required to grow by an average annual rate of 7 per cent for at least five years in order to accommodate the new entrants of 450,000 workers a year into the labour market and still reduce the overall unemployment rate by five percentage points. In Lebanon, official estimates indicate that the size of Lebanese labour force in 1998 was 1.36 million, 1.22 million of whom were employed, putting the unemployment rate at about 10 per cent. Unemployment in the Syrian Arab Republic was officially registered at 5 per cent in 1998. However, private estimates indicate significantly higher unemployment rates. The relatively high Syrian population growth of 3.5 per cent at the time of the country's economic slowdown must have significantly increased its unemployment rate or at least underemployment. As for the West Bank and Gaza Strip, the unemployment rate is preliminarily estimated to have declined from 20.9 per cent in 1997 to 15.6 per cent in 1998. The reduction in the number of days of border closing was the primary reason for such a significant decline.

8. The unemployment problem in the GCC countries is different from that in the more diversified economies. They have been typically labour-receiving countries in which millions of foreign expatriates work. Yet the rapidly increasing indigenous labour force in the GCC countries, which is growing by an average annual rate of 5 per cent, with a combined population growth rate estimated at 3.3 per cent annually, have forced the countries to seek appropriate policies to create adequate employment opportunities for their nationals. The current economic slowdown and the reduction in government revenues, however, limited these countries capacity to employ additional nationals in the private sector in 1998. At the same time, most employed nationals of the GCC countries work in the public sector, where both salaries and fringe benefits are much greater than in the private sector. Therefore, tremendous difficulty exists in encouraging the migration of indigenous labourers from public to private sectors. Most GCC countries have now taken concrete measures to increase training opportunities to their nationals and to make the private sector more attractive, with better fringe benefits and a guaranteed minimum wage. They also intensified efforts in 1998 to have their nationals replace expatriate workers whenever possible by giving incentives to private companies for employing nationals or levying penalties on those companies which do not meet a recommended quota of employed nationals in their workforce. Such indigenization policies are being enforced with varying degrees of success. Bahrain has been the most successful. Its public sector has the highest level of local employees among the GCC countries, estimated at about

90 per cent, while in the private sector Bahrainis account for 66 per cent, 38 per cent and 14 per cent of employees in the banking and finance, manufacturing and construction sectors, respectively. Oman has also achieved an albeit limited success in its Omanization endeavour in the banking and finance sector.

9. Unemployment in the ESCWA member countries is expected to worsen in 1999. Governments of the GCC countries and Jordan are expected to more forcefully apply the policy to replace expatriate workers by their nationals and continue with the policies of expelling illegal workers. Such enforcement will, in turn, add to the difficulties within Egypt, Lebanon, the Syrian Arab Republic and Yemen, which are traditionally labour-sending countries in the region.

10. Inflation rates had been declining in the ESCWA region in recent years. They are estimated to have fallen further in 1998 in most countries, except Yemen. Most GCC countries had lower inflation rates than the countries with more diversified economies, with the exception of Qatar. The latter is estimated to have witnessed moderate inflation of 3.5 per cent, which was higher than the inflation rate in Jordan at 2.5 per cent. Preliminary estimates indicate that four GCC countries — Bahrain, Kuwait, Oman and Saudi Arabia — experienced deflation in 1998. As the currencies of all the GCC countries are pegged to the United States dollar, with the exception of Kuwaiti dinar which is pegged to a basket of currencies, they appreciated along with the dollar against Japanese yen and most other Asian and Western European currencies. Consequently, the prices of imported goods to the GCC countries from most of their trading partners declined significantly. In addition, given the traditionally prudent monetary policies and the considerable reductions in government expenditures in the countries concerned, inflation rates were pushed further down to record low levels. At the individual country level, following a small deflation rate of 0.2 per cent in 1996 and a small inflation rate of 0.2 per cent in 1997, Bahrain is estimated to have registered 0.5 per cent deflation in 1998. Inflation rates in Kuwait have come down from 3.6 per cent in 1996 to 0.7 per cent in 1997, and finally plunged to a negative 1.3 per cent in 1998. While the Kuwaiti dinar is pegged to a basket of currencies, the United States dollar is still dominant in the basket. Thus, a relatively high share of imported goods in the Kuwaiti market resulted in the general decline in prices in 1998. Oman is estimated to have registered a deflation rate of 0.5 per cent in both 1997 and 1998. Qatar's inflation has been higher than that of any other GCC country in the last three years, and was the only rate that was higher than 1 per cent in 1998. While it fell from 7.4 per cent in 1996 and 6.2 per cent in 1997, the 1998 inflation rate still amounted to 3.5 per cent. One contributing factor was that the Qatar Government pushed for completing the construction of the natural gas projects and maintained expenditures at planned levels. Inflation rates in Saudi Arabia were 1.2 per cent in 1996, 0.1 per cent in 1997 and moved to a negative 0.8 per cent in 1998. Saudi Arabia curtailed government expenditures significantly in 1998, and also benefited from sharp declines in import prices and weaker upward pressure of wages given the country's economic slowdown. The inflation rate in the United Arab Emirates, as in Qatar, did not turn negative in 1998 since the Government apparently maintained its planned expenditures. Nevertheless, it has fallen below the levels in the previous years, 4.0 per cent in 1996 and 2.8 per cent in 1997, to 1 per cent in 1998.

11. Among the more diversified economies in the ESCWA region, Yemen is estimated to have witnessed the highest inflation rate — 12.2 per cent in 1998. Owing to its macroeconomic stabilization policies under the ongoing economic reform programmes since 1995, the country succeeded in reducing the high inflation of 30.2 per cent in 1996 to a moderate level of 5.4 per cent in 1997. The rate, however, has been on the upward trend due partly to depreciation of Yemeni rial against the United States dollar and partly to the Government policy of seeking complete elimination of price subsidies for basic commodities. The Syrian Arab Republic managed to reduce inflation rates gradually, from 8.2 per cent in 1996 to 8.3 per cent in 1997 and 4.9 per cent in 1998. Curtailed government expenditures, lower prices of imported goods and slower economic growth resulted in the continued reduction in inflation in 1998. Inflation in the West Bank and Gaza Strip has also come down steadily since 1996, following a substantial decline from 25 per cent in 1995 to 8.4 per cent in 1996 and 6.1 per cent in 1997. It is preliminarily estimated to have declined to 4.1 per cent in 1998. A sharp decline in the purchasing power of the Palestinian people in the presence of high unemployment and low economic growth may explain these notable changes. Lebanon's currency continued, albeit slightly, to appreciate against the United States dollar, contributing to lowering the prices of imports from Japan and other Asian countries in 1998. This was despite the 2 per cent across-the-board tariffs introduced during the year. Preliminary estimates indicate that the inflation in Lebanon was 3.8 per cent in 1998, 4.0 per cent lower than the 1997 level. The currencies of both Egypt and Jordan are basically pegged to the United States dollar and thus appreciated, along with the dollar, against the currencies of their trading partners in East and South-East

Asia. Thus, both countries benefited from the falling import prices. Inflation rates in Egypt came down from 7.2 per cent in 1996 and 4.6 per cent in 1997 to 3.6 per cent in 1998. Jordan also witnessed a gradual decline in its inflation rates, from 6.5 per cent in 1996 to 3.0 per cent in 1997, and to 2.5 per cent in 1998, at the time of reduced government expenditures, tight monetary policies and slowdown of economic activities.

12. Most ESCWA members are expected to experience upward edging inflation rates in the coming years, as import prices are expected to recover and government subsidies are either reduced or eliminated as part of economic reforms by some member countries.

13. The fiscal positions of Governments in the ESCWA region deteriorated in general in 1998 and the budget deficits as percentages of GDP increased considerably compared to the preceding two years. Among ESCWA member countries, only Lebanon managed to decrease its budget deficit, from 23.5 per cent of GDP in 1997 to 15.0 per cent in 1998, while Egypt maintained its budget deficit relative to GDP at basically the same level previously achieved; 1.0 per cent. All other member countries have registered widening deficit gaps, primarily owing to the steep decline in oil prices and hence oil export revenues. Particularly hard-hit were the GCC countries. These countries are usually known to be conservative in estimating oil revenues for the budget planning purposes, and used estimated oil prices between US$ 13 and US$ 15 per barrel in their planned budgets for 1998. In other words, Governments of the GCC countries predicted that 1998 oil prices would be 20 to 30 per cent lower than the 1997 average OPEC price of US$ 18.7. However, oil prices have turned out to be 34 per cent below the 1997 levels, resulting in a 5 to 18 per cent gap from the initial conservative estimates used. As a result, these countries were set back, at least temporarily, from achieving the previously set objectives of eliminating the budget deficits by year 2000. Kuwait had, in fact, registered a budget surplus at 11.4 per cent of GDP in 1997, but is estimated to have ended year 1998 with a deficit equivalent to 4.0 per cent of GDP.

14. Qatar's budget deficit in 1998 is estimated to have been 9.5 per cent of GDP, the highest ratio among the GCC countries. In order to complete its large-scale natural gas project, the Qatari Government failed to curtail expenditures below the initially planned level. The government expenditures were also not curtailed significantly in the United Arab Emirates, and thus its budget deficit is estimated to have amounted to 7.5 per cent of GDP in 1998, increasing from 3.9 per cent in 1997. All other GCC countries curtailed government expenditures as the oil prices continued to fall throughout 1998 to levels significantly below those planned, and thus their budget deficits remained at relatively small percentages of GDP; 4.0 per cent for Bahrain and Kuwait and 5.0 per cent for Saudi Arabia. Oman is estimated to have registered the lowest budget-to-GDP ratio among the GCC countries in 1998 at 2.8 per cent, although it was above the 1997 ratio of 0.7 per cent. Not only were Oman's initial budget revenue estimates among the most conservative but also government expenditures were reduced by more than 10 per cent during 1998. Moreover, the country has benefited from its economic reform and revenue diversification policies, while its liquefied gas exports increased in 1998, contributing more than 10 per cent of the government revenues.

15. The significant decline in Lebanon's budget deficit relative to GDP in 1998 may be attributed to an improved tax collection system, a 2 per cent across-the-board tariff on imported goods and much higher percentages on luxury imports, a 5 per cent service surcharges on hotel and restaurant services, and increased tax revenues from gasoline. Lebanon would have recorded a budget surplus for the first time in many years had it not been for the heavy debt service obligations, which accounted for about half of the Government revenues. While Egypt is an oil-exporting country, its economy is fairly diversified and oil revenues do not account for a dominant part of the total government revenues. In addition, the country's accelerated privatization endeavour during 1998 brought in sufficient government revenues. Therefore, Egypt managed to maintain the ratio of budget deficit to GDP ratio at 1.0 per cent, the lowest among all ESCWA member countries. In the remaining more diversified economies — Jordan, the Syrian Arab Republic, and Yemen, the budget deficit as a percentage of GDP is estimated to have increased in 1998 to 9.3 per cent, 3.6 per cent and 4.0 per cent, respectively, after declining in 1997 from the 1996 levels. Despite the curtailment of government expenditures at the time of dismal economic conditions in the ESCWA region, the sharp drops in government revenues in these countries were too large to be compensated.

16. Budget deficits to GDP ratios of ESCWA member countries are expected to decline in 1999, reversing the 1998 results, as member Governments will better adjust expenditures to expected revenues. Significant increases in non-oil revenues among some members in the region will also help.

II. Monetary, fiscal and financial developments

17. During the past few years, deceleration in the growth of money supply has been particularly pronounced among the GCC countries. This development was matched by similar deceleration in the growth of bank credit to the private sector. Contributing factors included changes in the composition and level of government expenditures and the restraints on bank credit, which were exercised through changes in interest rates, reserve or liquidity ratios and credit ceilings. In addition, morale suasion was applied for the purpose of directing bank credit to preferred areas, encouraging the sale of treasury bills, notes and bonds, and increasing outflow of liquidity in the form of current and capital transfers for import financing and investment. For example, in Egypt, Jordan, Kuwait, Lebanon, Oman and the United Arab Emirates, a series of measures were undertaken to regulate liquidity and improve monetary management. Such measurements included (a) introduction of a system to allow for a variety of liquidity ratios in the bank deposit structure, (b) allocation of bank current accounts in cash, in time and savings deposits with the central banks, or in current deposits with other local banks at specific rates, (c) currency swap arrangements among local banks to minimize the risk of foreign exchange fluctuations, (d) issuance by the central banks of bills and notes to the account of the finance ministries in order to lay the basis for "open-market operations", and (e) interbank operations, involving bank holding deposits and certificates of deposits.

18. Until 1998, there was an absence of a proper definition for aggregate money supply in the ESCWA region. No definition existed which would take into account money, credit and financial market instruments, nor include these instruments in the respective money supply aggregates. Consequently, the composition of money supply remained unclear, and a misleading interpretation of the growth rates and movements in money supply resulted. Therefore, the relationships between measures of money supply and economic performance have not been accentuated in any ESCWA member country, nor have money growth targeting procedures been established. Inevitably, the task of stimulating the economy was left entirely to budgetary policies.

19. Monetary policies of most ESCWA member countries have changed fundamentally during the past few years. This is particularly clear with respect to enlarging the availability of financial resources according to the level of economic development. To enhance the effectiveness of monetary policies, functions of the financial system itself were changed with the resulting improvement in the process of mobilizing and allocating financial resources and the stronger monetary control mechanism. Achieving these objectives, in turn, necessitated enhancement of the role of market forces in the determining rates of return and credit allocation. A number of ESCWA members, most notably Egypt and Jordan, where economic structural adjustment programmes were implemented, made progress during the first half of the 1990s in liberalizing the structure of interest rates, especially those on deposits, and in reducing the scope of preferential rates, particularly for public-sector enterprises.

20. Despite significant drops in the oil revenues of the GCC countries in 1998 as discussed above, oil revenues continued to contribute a high percentage, between 70 and 90 per cent, of total budget revenues of these countries. Due to such heavy dependence on oil exports, the drop in oil revenues in 1998 affected all aspects of economic activities in the GCC countries, inducing urgent and immediate changes in economic and financial policies. As a result of reassessing their financial and development programmes, the GCC countries introduced important budgetary restraints in fiscal 1999. The 1999 budgets of most of these countries represent a cut or slowdown in the pace of growth in capital expenditures. Moreover, no new development projects seem to have been introduced in these budgets. Capital spending would most probably be limited only to small projects or to those already initiated under previous commitments. However, current expenditures, which comprise mainly defence, wages and salaries, subsidies and services, proved to be more difficult to be curtailed. Inevitable budget deficits of the GCC countries were financed, partly by drawing on their reserves and partly by placing some debt instruments, such as government bonds and treasury bills and notes, in the second half of 1998. This pattern is expected to continue in the coming years, as the GCC countries are expected to face difficulty in establishing a balanced budget in light of the recent development in world oil markets. Drops in the oil revenues in 1998 also forced the GCC countries to pay more attention to escalating costs of subsidies and justification for sustaining their budgetary burden. This has been particularly true of subsidies on water and electricity, which are offered at prices not covering even a fraction of their production costs. In 1999, Governments of the GCC countries are expected to continue curtailing expenditures while encouraging the private sector's more active involvement in the economy.

21. The ESCWA member countries with more diversified economies shared three main common characteristics with

respect to their budget revenues in 1998: (a) increased shares of domestic revenues in current expenditures and part of capital expenditures; (b) declines in the level of foreign aid and the negative spillovers from the GCC countries; and (c) rising levels of domestic public debts. Similarly to the GCC countries, this group also pursued tight fiscal policies in 1998, restricting the growth of both current and capital expenditures. Efforts were made in most of these countries, particularly in Egypt and Jordan, to reduce the amount of subsidies relative to total current expenditures. Improvement in the efficiency in tax collection and public administration in most of these countries during the past few years also contributed to a rise in their domestic revenues. Nevertheless, their taxation systems do not play an effective role of mobilizing available domestic financial resources. The economic reform programmes currently under way in some of these countries are expected to make marked changes in resource allocation within the next few years. Moreover, unlike the GCC countries that could finance their short-term budget deficits by drawing on their foreign reserves, most more diversified economies may have to look for alternative sources to reduce their budget deficits. An increase in budget revenues through a reform of revenue-raising measures, improvement in tax collection methods and a reduction in the growth rate of budget expenditures through reducing subsidies or debt service payments are a few examples.

III. Developments in the external sector

22. The ESCWA region's international trade accounted for only 2.1 per cent of the world total trade volume in 1996/97, indicating a significant decline from 7.2 per cent in 1980/81. The 1996/97 oil exports from ESCWA accounted for 75 per cent of the region's total exports. Due to the collapse in oil prices in 1998, oil export revenues of the ESCWA region as a whole were adversely affected. The total value of the region's exports in 1998, excluding the West Bank and Gaza Strip, is estimated to have been US$ 97.1 billion, representing a drop of 21.7 per cent from the 1997 level. Optimistic forecasts for 1999 are that an improvement in the world oil prices will lead to an increase in the region's export revenues by 8 per cent.

23. Export revenues of the GCC countries, which contributed more than 80 per cent of the ESCWA region's total, are estimated to have amounted to US$ 79.4 billion in 1998, indicating a severe decline of 26.4 per cent from the 1997 revenues. Total exports of Kuwait and Saudi Arabia are estimated to have declined by 31.0 per cent and 28.5 per cent, respectively, in 1998, registering the largest percentage declines among the GCC countries. Bahrain's total exports declined by 19.8 per cent, the smallest percentage in this group. For the other GCC countries, preliminary estimates of their 1998 total exports show a decrease of 21.1 per cent in the United Arab Emirates, 24.3 per cent in Oman and 25.6 per cent in Qatar, compared to 1997. In contrast with the GCC countries, the countries with more diversified economies are estimated to have registered an increase in their combined total export revenues by 10.0 per cent in 1998 from the 1997 level. The main contributing factor was an increase in Iraqi exports as a result of the oil-for-food deal agreed in February 1998. However, total exports of three countries in this group in 1998 are estimated to have dropped significantly from 1997. They include Yemen, with the highest rate of decline at 30.5 per cent, the Syrian Arab Republic, with a 20.4 per cent decline, and Egypt, with an 11.7 per cent decline. For Jordan and Lebanon, non-oil exporters, their exports are estimated to have increased by 5.1 per cent and 15.3 per cent, respectively, in 1998.

24. The total import values of the ESCWA region in 1998 are estimated to have registered a 2.6 per cent decline from the 1997 level. Two primary reasons are the sharp fall in their oil revenues, which are normally the major source of financing imports, and a significant decline in the commodity prices in the world markets during 1997 and 1998. Furthermore, the value of imports from several East Asian countries declined, owing mainly to depreciation of their respective currencies. In 1999, the ESCWA region's total imports are projected to increase by 1.1 per cent.

25. Import values of the GCC countries as a whole in 1998, which accounted for more than 70 per cent of the region's total imports, are estimated to have decreased by 4.8 per cent from the 1997 values. They are projected to increase slightly, by about 0.6 per cent, in 1999. All the GCC countries are estimated to have witnessed their imports decline, while the magnitudes varied within the group between 3.0 per cent in Oman and 6.5 per cent in the United Arab Emirates. In 1999, however, imports by the GCC countries are forecasted to increase, with the exception of Saudi Arabia's, which are expected to decline by 1.0 per cent. Bahrain's imports are expected to record the lowest increase of 1.1 per cent in the group, while the imports of the United Arab Emirates will increase by 3.2 per cent. For the more diversified economies, preliminary estimates for 1998 indicate that their total imports as a group achieved a growth rate of 2.1 per cent, owing primarily to the increase in Iraq's imports, and are projected to increase by almost the same rate in 1999.

However, the imports of three countries in this group are estimated to have decreased significantly in 1998 from the 1997 levels — Jordan by 8.6 per cent, Lebanon by 7.2 per cent and Yemen by 6.6 per cent. The imports of both Egypt and the Syrian Arab Republic are estimated to have declined by lower rates, 3.5 per cent and 4.9 per cent, respectively. In contrast, imports by all countries in this group are expected to increase in 1999, at growth rates between 2.3 per cent in Egypt and 3.4 per cent in the Syrian Arab Republic.

26. While the combined trade balance in the ESCWA region had achieved a surplus of US$ 14.5 billion in 1997, it is estimated to have recorded a deficit of US$ 9.4 billion in 1998 as a result of the sharp decline in total export revenues. In 1999, the region's trade balance is projected to remain in deficit and register about US$ 2.9 billion. For the GCC countries as a group, the balance of trade is estimated to have recorded a surplus of US$ 7.1 billion in 1998, compared with a much larger surplus of US$ 32 billion in 1997. In 1999, it may achieve a surplus of US$ 13 billion. Examined individually, three countries in this group — Saudi Arabia, Kuwait and Oman — are expected to have achieved a surplus, while the other three are estimated to have recorded a deficit in 1998. As for the more diversified economies, their combined trade balance is estimated to have registered a deficit of about US$ 16.5 billion in 1998, and forecasted to remain in deficit at US$ 16 billion in 1999. All the countries in this group, excluding Iraq under the United Nations economic sanctions, are expected to have trade deficits in 1999, as a group and individually.

27. The export/import ratio of the ESCWA region as a whole reached 1.13 in 1997, representing a slight decline from the 1996 level, and is estimated to have deteriorated in 1998 to reach only 0.91. It is projected to increase slightly in 1999 to 0.97. For the GCC countries, this ratio decreased from 1.42 in 1997 to 1.1 in 1998, and is forecasted to increase in 1999 to reach 1.18. For the more diversified economies, the ratio is estimated to have increased from 0.48 in 1997 to 0.51 in 1998, and projected to rise further in 1999 to 0.54.

28. Exports of mineral fuels contributed 75 per cent of the ESCWA region's total exports in 1997. The share of mineral fuels in total exports was 84.2 per cent among the GCC countries as a whole, although it varied from country to country. The share registered 62 per cent in Bahrain, 76 per cent in Oman and 97 per cent in Kuwait. The structure of exports of the more diversified economies notably differs from that of the GCC countries. Exports of mineral fuels accounted for 52.7 per cent of their total exports as a group, while the contributions of food and live animals as well as manufactured goods were both about 11 per cent. Egypt's exports of manufactured goods reached 25.6 per cent of its total exports, and the share of exports of mineral fuels was 45.3 per cent. While Jordan and Lebanon are not mineral fuels exporters, Jordan's exports of crude materials and chemicals are on the rise, and manufactured goods contributed significantly to Lebanon's exports. In the Syrian Arab Republic, mineral fuels as well as food and live animals represented most of its exports, with their shares at 63.6 per cent and 18 per cent, respectively. As for the Republic of Yemen, the exports of mineral fuels contributed more than 95 per cent of its total exports.

29. Three categories of imported goods formed most of the ESCWA region's imports, with machinery and transport equipment contributing 30.7 per cent of the total imports, manufactured goods contributing 19.4 per cent and food and live animals 15.9 per cent. The import structure of the GCC countries as a group is similar to that of the entire ESCWA region, with the contribution of machinery and transport equipment being slightly higher at 37.8 per cent. Bahrain's import structure is different from the rest of GCC countries, with its mineral fuels imports representing the highest contribution in the ESCWA region at 36.6 per cent due to refinery and re-export operations, and the imports of machinery and transport equipment accounting for only 18.3 per cent. The shares of machinery and transport equipment imported varied among other GCC countries, from 35.5 per cent in Saudi Arabia to 50.6 per cent in Qatar. Among the more diversified economies, the contribution of machinery and transport equipment to total imports registered 25.8 per cent. In addition, the shares of food and live animals as well as manufactured goods imported by those countries were about 20 per cent. While these three items formed most of the imports of Egypt, Jordan, Lebanon and the Syrian Arab Republic, the imports of food and live animals by Yemen contributed about 28.5 per cent of the country's total imports, the highest percentage in the ESCWA region.

30. Developed market economies represent the largest export outlets for the ESCWA region, and their share in the region's total trade volume increased from 48.2 per cent in 1996 to 50.4 per cent in 1997. While the share of exports to the European Union (EU) decreased significantly from 17.9 per cent to 13.8 per cent in the same period, there was no change in the shares of Japan and the United States of America, accounting for 22 per cent and 9.2 per cent, respectively. The share of developing countries decreased slightly from 42.3 per cent to 41 per cent, due to the reduction in the share of Asian developing countries by almost 2 per cent at the time of the Asian crisis. As for

imports by the ESCWA region as a whole, the total volume from developed market economies decreased slightly, by 0.6 per cent. The share of the EU decreased by 2 per cent between 1996 and 1997, while there was no significant change in the share of either the United States or Japan. Moreover, the share of imports from developing countries decreased by 1.5 per cent, while the imports from the Asian developing countries jumped from 15.5 per cent to 20.2 per cent, owing mainly to the depreciation of their local currencies.

31. The ESCWA intraregional trade improved in 1997, reaching 8.6 per cent of the region's total exports and 10.8 per cent of total imports, up from the 1990–1996 average levels of 7.9 per cent and 9.2 per cent, respectively. However, intraregional trade within ESCWA is still very limited, compared with 38.7 per cent in the North America Free Trade Area or 57.5 per cent in the EU. Combined interregional exports and imports among the GCC countries reached 7.6 per cent and 8.5 per cent, respectively, of their total export and import volumes in 1997. The share of intraregional trade of the more diversified economies was slightly higher, at 17.7 per cent of the total exports and 9.3 per cent of total imports. The 1997 intraregional trade balance recorded a surplus for the GCC countries at US$ 40 million and a deficit at US$ 697 million for the more diversified economies.

32. The current account balance of the ESCWA region, excluding Qatar, the United Arab Emirates, Iraq and Lebanon for lack of data, recorded a surplus of US$ 9.5 billion in 1997, representing an increase of about 18 per cent from the 1996 level. In 1998, it is estimated to have recorded a deficit as a result of the drop in the export revenues. The GCC countries as a group had a surplus of about US$ 8.8 billion in 1997, 8.7 per cent over the 1996 level. Only Oman in this group had a deficit at US$ 54 million. The more diversified economies also achieved a surplus in 1997 of US$ 726 million in contrast to a deficit recorded in 1996. All the countries in this group had a surplus in 1997, with the magnitudes varying between US$ 15 million in Jordan and US$ 464 million in the Syrian Arab Republic.

33. Tourism receipts of the ESCWA region, excluding Qatar and the United Arab Emirates due to lack of data, reached about US$ 8 billion in 1996, compared with US$ 7.3 billion in 1995. The contribution of the GCC countries to the region's total receipts was 22.6 per cent, with Saudi Arabia the leader in this group at US$ 1.3 billion. The more diversified economies have contributed US$ 6.2 billion, or 77.4 per cent of the total region's receipts. Egypt is the largest country in the region in the area of tourism, its receipts representing about 40 per cent of the region's total receipts, and 4 per cent of the total Egyptian GDP. In 1996/97, the country's tourism revenues reached US$ 3.4 billion. The second country in this group is the Syrian Arab Republic, with its tourism revenues reaching about US$ 1.5 billion in 1996. Tourism receipts of Jordan and Lebanon in the same year reached US$ 770 million and US$ 715 million, respectively.

34. Combined workers' remittances of five ESCWA member countries — Egypt, Jordan, Lebanon, Oman and Yemen — totalled about US$ 8.1 billion in 1996, representing an increase of 0.9 per cent over the 1995 level. Workers' remittances in Egypt, the leading labour-sending country in the region, reached US$ 3.5 billion in 1997/98 compared to US$ 3.25 billion in 1996/97. The remittances to Lebanon reached about US$ 2.5 billion in 1996, representing 53 per cent of the country's total exports of goods and services. In Jordan and Yemen, their expatriate workers' remittances reached US$ 1.5 billion and US$ 1.1 billion, respectively. In contrast, Omani workers' remittances were very small, only at US$ 39 million in 1996.

35. International reserves, minus gold, in the ESCWA region, excluding Iraq and the Syrian Arab Republic for lack of data, increased as of May 1998 by 1.3 per cent over the 1997 level to reach US$ 53.7 billion. The GCC countries' international reserves, accounting for 45.2 per cent of the ESCWA region's total reserves, increased by 3.2 per cent in 1998 from 1997. The GCC countries' international reserves could cover imports for only 3.7 months in 1998, compared with an average of 12.5 months in the 1970s and an average of 8.2 months in the 1980s. The international reserves of the countries with more diversified economies as a whole was US$ 29.4 billion in 1998, indicating a 0.2 per cent decrease from the amount in 1997. Egypt's international reserves reached US$ 20.1 billion, the largest among all ESCWA member countries, accounting for 37.4 per cent of the total reserves in the region in 1998. This large amount was sufficient to finance the country's imports for 18.4 months, in contrast to an average of only a one-month period during the 1970s and the 1980s. The international reserve positions also improved in Jordan, Lebanon and Yemen to cover the imports of about 6 months in both Jordan and Yemen, and 9.6 months in Lebanon in 1998.

36. External debts of six ESCWA member countries — Egypt, Jordan, Lebanon, Oman, the Syrian Arab Republic and Yemen — were reduced significantly during the 1990s. The combined total debts of these countries was US$ 71.6 billion in 1996, a 4.77 per cent decline from the 1995 level. Egypt had been the most indebted country in the region but has made a significant progress since the second half of the

1980s, with its external debt reaching US$ 29.98 billion in 1997. This amount indicated a 6.22 per cent decline from the 1996 level and represented 46.3 per cent of GDP. In the Syrian Arab Republic, external debt recorded a slight increase of 0.48 per cent in 1996 over 1995 to reach US$ 21.4 billion, 130.5 per cent of total GDP. Jordan's external debt decreased by 5.55 per cent in 1997 from the 1996 level, registering US$ 7.7 billion, 109.5 per cent of the country's GDP. External debt of Yemen had been reduced significantly at a rate of 46.73 per cent between 1995 and 1996 but increased slightly in 1997 to reach US$ 3.35 billion, 62.1 per cent of GDP. Lebanon's external debt increased sharply in 1997 at a rate of 25.5 per cent over the 1996 level to reach US$ 5.0 billion. Oman's external debt reached US$ 3.4 billion in 1996, which was low relative to the country's GDP, about 24.6 per cent.

IV. Environmental conditions

37. While most ESCWA members are blessed with their large combined oil and natural gas reserves, the region is less fortunate in general with respect to two other critical natural resources — productive land and accessible renewable water resource. The region's accelerated economic growth and development and urbanization during the past decades has evidently been posing significant pressures on its limited natural resources and putting stress on the environment. In the absence of integrated national conservation strategies, the abuse of soil and water has led to soil degradation, loss of fresh non-renewable water reserves and deterioration in water quality. The limited capacity of the ESCWA region's fragile ecosystems to exploit natural resources and process the generated wastes, as well as its life-supporting potential, are becoming rapidly jeopardized.

38. More than three quarters of the land in Western Asia is desert, and an increasing part of the permanent pasture has been subject to soil erosion as a result of the reduced vegetation cover. Agriculture in the ESCWA region remains severely constrained by limited arable land, scarcity of suitable water resources and unfavourable arid climatic conditions. The aridity of the environment, deforestation, overgrazing and the extension of cereal crops into range land have led to the deterioration of natural vegetation cover and accelerated desertification. Most Governments of the region, particularly those of Jordan, Lebanon, Saudi Arabia, the Syrian Arab Republic and the United Arab Emirates, have exerted efforts in forest conservation, green belt development, biological sand dune fixation, roadside plantation, afforestation and reforestation, and have succeeded in stabilizing the situation to a great extent.

39. Water scarcity in the ESCWA region dictates that the region's overwhelming environmental priority be the conservation and protection of its water resources. At present, the unsustainable withdrawal of water from currently available surface and groundwater supplies is a major cause of water scarcity in the region. In addition, the progressive deterioration in the quality of groundwater is a major issue to be addressed in the entire region. The discharge of raw and partially treated wastewater from agriculture, industry and municipalities into water courses has not only subjected agricultural land and water resources to severe pollution but also caused great concern to public health. The urgent need for safe drinking water increased the demand on desalinated water, with negative environmental implications and the overdrafting of exhaustible groundwater resources.

40. Industrial activities in the ESCWA region consist mainly of extraction and manufacturing. While massive and modern industrialization continues with progress in incorporating advanced technologies into the national infrastructures, the region's environmental interest remains negligible in general. For example, technological advancement and know-how is limited in the areas of processing, recycling and reprocessing. Environmental aspects have been practically ignored in the decision-making process for setting up industrial activities in most of the ESCWA member countries. The marine environment in the region is also increasingly threatened, particularly in the near shore. Contributing factors to the marine environmental deterioration include oil exploration and exploitation, rapid economic growth, overfishing, physical alteration of the coastlines by dredging and filling, discharge of raw sewage, disposal of untreated industrial effluents, and dumping wasted oil and debris. The situation has been further complicated by continuous population encroachment onto the coastal areas.

41. Human activities in the ESCWA region are concentrated in urban areas, thereby creating heavy demand for natural resources, such as energy, fresh water, food and land, as well as the demand for basic services and infrastructure, such as sanitation and waste disposal services, education, health care, roads and public transportation. These patterns will ultimately lead to a high rate of environmental degradation by augmenting the emission of air pollutants, water pollutants, domestic wastes, toxic and hazardous wastes, depletion of resources etc. The region has a diversity of habitats due to its characterized variations in climate, geology, amount and distribution of rainfall, and

elevation. Recent experience of overgrazing, deforestation and hunting have, however, resulted in desertification and the extinction of some native plants and animals.

42. ESCWA member countries are facing severe environmental degradation caused by high rates of population growth and economic growth, along with the accelerated urbanization. At the same time, environmental protection measures are not stringent in the region in general, thus leading to serious deterioration in the environmental and health conditions. Reasons for this unsustainable pattern of development in the ESCWA region include poor institutional arrangements, deficiency in environmental, economic and social information, a lack of public participation in the decision-making process, and severe inadequacy in institutional capacities and qualified human resources.

43. The issue of environmental dumping is particularly important in the ESCWA region since many of its member countries are in the process of opening their economies to foreign investors and encouraging export oriented industries. Integrating environment management into socio-economic development planning and decision-making processes is crucial but has not been taken seriously. Hence, an absolute failure in adopting long-term strategic perspectives has resulted. Nonetheless, environmental management has received greater attention on the global scale over the last few years, with the popularization of the concept of sustainable development. This newly developed trend has prompted policy makers of the ESCWA member countries to review their older ideas and tools of environmental management and seek strategies to implement intricate formulas of coordination and integration of environmental issues in development planning.

44. Development of national environmental strategies and action plans is a powerful tool in this direction. Improving environmental institutions and management systems by allocating resources and linking environmental issues with economic planning and policy-making is considered a top priority for achieving sustainable development. In addition, public participation in the environmental aspects of socio-economic development will enhance the decision-making process and ensure its implementation.

V. Social developments

45. The United Nations development decades, which began in the early 1960s, are drawing to the end of their fourth term. While international and regional efforts at dealing with development goals to attain social justice continue unabated, these efforts continue to be marred by political tension and financial turmoil. The crises in Asia in 1997–1998 and in the Russian Federation in 1998 affected world financial and trading markets, which in turn created severe obstacles to attaining social development goals in many countries. The overall development efforts of ESCWA member countries are being tested, as indicated by bleak forecasts for employment, economic growth and international financial stability. Political tension and non-adherence to the Security Council resolutions in the region continue to divert precious resources into arms and military expenditures, rather than being used for achieving socio-economic development objectives.

46. The population of ESCWA member countries grew, between 1978 and 1998, from 87.8 million to 157.6 million, indicating an average annual increase of 2.9 per cent. The population in the region as a whole is projected to reach 166 million by 2000 and 210 million by 2010, accounting for 5.0 per cent of the population in Asia and 3.1 per cent of the world population. The region's population is relatively young, with a large proportion under the age of 15: in 1998, about 41 per cent of the population were below 15 years of age, while only 4.0 per cent were older than 65. The total fertility rate declined from 6.8 in 1978 to 4.4 in 1998, or by 2.1 per cent annually. Nevertheless, with the disproportionately high percentage of young people reaching childbearing ages, the growth momentum will increase the region's population rapidly in spite of the decline in the average fertility rate. Another factor contributing to the rapid increase in the population is improvement in average life expectancy at birth: it was recorded at 71.0 for females and 68.2 for males in 1998. Compared to two decades ago, women now live 8.9 years and men 9.2 years longer. Iraq is the only country where life expectancy at birth dropped, by 3.2 years for men and 1.9 years for women.

47. Given the rapid increase in the number of the unemployed in the ESCWA region, new entrants to the labour force that do not find appropriate jobs represent a greater threat to social stability than the long-term unemployed who would have joined the informal sector. In Egypt, for example, traditional labour-absorbing mechanisms — government employment, public enterprises, and to a lesser extent external migration — are no longer effective. At the same time, job creation in the private and

manufacturing sector has been slow and unable to absorb the excesses in the public sector. Most new jobs are in the low-productive, low-wage service and agricultural sectors, thus resulting in the continued deterioration of labour productivity. One solution is to upgrade the quality of education to meet the technical requirements of the twenty-first century, with emphasis on cognitive and technically advanced skills. Such improvements require reconsidering government budget allocations to reflect increases in the number of higher educational institutes and expansion of vocational training programmes. The role of the private sector should also be restructured to become complementary to the public sector.

In spite of considerable progress made in the status of the Arab women in the ESCWA region over the past decades, the gender gap in socio-economic status persists in most of the countries in the region. The continued inadequate participation in education for girls and adult women has serious negative implications for their skill development and thus their employment opportunities, exacerbating the difficulties in accessing economic activities that can enhance income and revenue. Political participation by Arab women has also improved. For example, the number of ESCWA member countries that grant women the right to vote has increased since the 1970s. The number of women elected to parliaments has also risen. In 1998, the Syrian Arab Republic had the highest count in the region, with 24 women in its parliament. However, at the regional level, women still occupy a negligible 3 to 4 per cent of the total number of the country's parliamentary seats. Moreover, women's appointments to high-ranking government posts or executive levels with decision-making capacities continue to be limited.

49. While there has been an increase in the percentage of women in the labour force in the ESCWA region, their participation continues to remain low compared to men. This may be the result of several factors: the prevalence of early marriages, high fertility rates and family responsibilities, as well as lingering sociocultural restrictions on female employment. In addition, women's participation in the labour force is usually complex since they are expected to perform multiple roles, such as career, housekeeping and child-caring functions. The highest percentages of economically active women in the region have been recorded in Lebanon and Egypt, while the lowest rates have been in the GCC countries. The majority of working women in most ESCWA member countries are employed in the services sector, which is considered socially and culturally more acceptable. In some countries, however, the concentration of women in the primary sector is relatively high, but they are under-represented in the industrial sector. For example, in Egypt, the Syrian Arab Republic, and Yemen, 50 to 60 per cent of the working women are engaged in the agricultural sector.

50. Urban population has been growing faster than both total and rural population in the ESCWA member countries as a whole. While in 1975 only 47 per cent of the region's total population lived in urban areas, this number increased to 53 per cent in 1985 and 57 per cent in 1995, and is expected to reach about 60 per cent by 2000. This development indicates that urbanization in the region is progressing faster than in other developing countries, in which only 41 per cent of total population are expected to live in urban areas in year 2000. Despite crowded living conditions and poor quality of service delivery in most large cities in the ESCWA region, their continued growth is indicative of the comparative advantage of living that they offer compared to smaller towns and villages. Such urban bias is understandable, as cities generate employment or prospects for employment for new migrants. Urban services, including housing, education, health, and recreation, also tend to be of a better quality than those provided — if available at all — in rural areas. The discrepancy between urban and rural areas is particularly striking in the case of access to safe drinking water and sanitation.

51. Most ESCWA member countries have made considerable progress in extending infrastructure facilities to dwelling units, particularly in urban areas. Some 75 to 90 per cent of households in the GCC countries have direct connection to water and sewage networks, and over 95 per cent of dwellings in these countries are connected to kitchen and bathroom facilities. However, lower income countries of the region have achieved more modest progress. For example, only 42 per cent of households in Egypt are directly connected to water and sewage networks. Furthermore, in squatter settlements at Sana'a and Hodiedah, the West Bank and Gaza, Beirut, Baghdad, Amman, Aqaba, to name a few, households lack any access to adequate housing, sanitation and refuse collection, thus resulting in serious environmental problems. In contrast, there have been remarkable achievements in extending electricity in most countries of the region, and the urban — rural gap in this respect is minimal.

Socio-economic indicators for the ESCWA region, 1996–1998

	1996	*1997*	*1998[a]*
Gross domestic product (GDP) (billions of US dollars at constant 1992 prices)[b]	312.33	322.87	326.14
Real GDP growth rate (percentage)[b]	3.7	3.4	1.0
Population (millions)[b]	126.26	129.50	132.82
Population growth rate (percentage)[b]	2.5	2.5	2.5
GDP at nominal prices (billions of US dollars)[b]	354.4	379.3	395.9
Exports (billions of US dollars)[c]	127.8	123.9	97.1
Imports (billions of US dollars)[c]	104.5	109.4	106.5
Balance of trade (billions of US dollars)[c]	23.2	14.5	(9.4)
Current account balance (billions of US dollars)[d]	8.1	9.5	N/A
International reserves (billions of US dollars)[e]	48.6	53.0	53.7
International reserves/import ratio (months)[e]	5.6	6.2	6.1
Crude oil production (millions of barrels per day)	16.4	17.3	18.3
Crude oil revenues (billions of US dollars)	97.4	94.8	67.7
Proven oil reserves (billions of barrels)	489.5	490.0	586.2
Proven oil reserves/total world oil reserves (percentage)	56.0	56.8	57.5
Proven oil reserves/production (years)	96.2	92.2	89.2

Source: Economic and Social Commission for Western Asia, based on national and international sources.

Note: Parenthesis ( ) denotes a deficit or negative; N/A denotes data are not available.

[a] Preliminary estimates.

[b] Excluding Iraq and the West Bank and Gaza Strip due to lack of comprehensive data.

[c] Excluding Iraq due to lack of comprehensive data.

[d] Excluding Iraq, Lebanon, Qatar, United Arab Emirates, and West Bank and Gaza Strip due to lack of comprehensive data.

[e] Excluding Iraq, Syrian Arab Republic and West Bank and Gaza Strip due to lack of comprehensive data.